ISLAMIC DEVELOPMENT BANK
ISLAMIC RESEARCH AND TRAINING INSTITUTE

ISLAMIC BANKING: ANSWERS TO SOME FREQUENTLY ASKED QUESTIONS

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FOREWORD

In the last quarter of a century, there has been a great interest in the Islamic banking system both at private and public levels. There is an earnest and widespread desire to understand the system. Academicians, bankers and general public, all, have some genuine questions and concerns. Policy makers in the monetary and financial sectors of the IDB member countries have also often asked the Islamic Research and Training Institute (IRTI) some basic questions of theoretical and practical importance about the elimination of interest from the national economies of Muslim countries and the transformation of the prevailing conventional system to an Islamic one. Some of these questions reflect a desire to understand the basic concepts of Islamic finance while others relate to the creation of an enabling environment through macroeconomic reform and structural adjustments that are needed to establish the Islamic financial system and the complications that arise when an effort is made to bring about the transformation without creating such an environment.

In this study, an attempt has been made to answer some of these questions. Munawar Iqbal, Chief, Islamic Banking and Finance Division prepared the first draft. The second draft was prepared jointly by him and Mabid Ali Al-Jarhi, Director, IRTI. That draft was thoroughly reviewed by M. Umer Chapra, Research Advisor of IRTI. This final version reflects the substantial revisions made by him.

Although an attempt has been made to respond to all major questions and concerns, there may be some that remain unanswered. IRTI, therefore, stands ready to add to or modify this volume in response to suggestions from policy makers and scholars. We hope that this humble effort will, on the one hand, assist those who want to understand the Islamic banking system and on the other, become a practical guide for those working for a well-targeted transformation of their financial system into one that reflects the teachings of Islam.

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PART 1

RIBĀ AND INTEREST

The consensus of Islamic jurists, *fuqahā',* as well as specialists in Islamic Economics has been that interest is equivalent to what is termed in the *Sharīʿah* as *ribā*, which is strongly condemned. This has manifested itself in the judgments issued by national *fiqh* academies as well as the Islamic Fiqh Academy of the Organization of the Islamic Conference (OIC), Jeddah. The following questions highlight the main aspects of this topic.

Q.1) THE HOLY QUR'ĀN HAS PROHIBITED *RIBĀ*. WHAT IS MEANT BY THIS TERM?

The word *ribā* as a noun literally means in Arabic, an increase, and as a root, it means the process of increasing. *Ribā* has been understood throughout Muslim history as being equivalent to interest paid on a loan.

Sharīʿah scholars have used the term *ribā* in three senses; one basic and two subsidiary. In its basic meaning *ribā* can be defined as "anything (big or small), pecuniary or non-pecuniary, in excess of the principal in a loan that must be paid by the borrower to the lender along with the principal as a condition,[1] (stipulated or by custom), of the loan or for an extension in its maturity."[2] This is called *ribā al-qarḍ* or *ribā al-nasa*. It is also referred to as *ribā* al-Qur'ān as this is the kind of *ribā* which is clearly mentioned in the Qur'ān and is known today as interest on loans.

However, the term *ribā* has a more comprehensive implication and is not merely restricted to loans. Even though Islam has allowed the sale of goods and services, *ribā* may surreptitiously even enter into sales transactions. Hence the two subsidiary meanings of *ribā* relate to such transactions and fall into the category of *ribā al-buyūʿ* (*ribā* on sales). The first of these is *ribā al-nasī'ah*, which stands for the increase in lieu of delay or postponement of payment. The

[1] Thus any excess given by the debtor out of his own accord, and without the existence of a custom or habit that obliges him to give such excess is not considered as *ribā*.

[2] For some other definitions of *ribā* and discussions thereupon, see Islamic Research and Training Institute (1995), pp.77-84.

second is *ribā al-faḍl,* which relates to the purchase and sale of commodities. In this context, *ribā al-faḍl* refers to the excess taken by one of the trading parties while trading in any of the six commodities mentioned in a well-known authentic *ḥadīth*:

> *Abū Saʿī d al Khuḍrī* narrated that the Apostle of Allah (Peace be upon him) said: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, like for like, payment being made hand by hand. If anyone gives more or asks for more, he has dealt in *ribā*. The receiver and giver are equally guilty" (Muslim).

It must be mentioned that economically speaking it would be irrational to exchange one kilogram of wheat with one and a half kilogram of wheat in a spot exchange. Therefore, some *fuqahā'* have pointed out that *ribā al-faḍl* has been prohibited because if left unprohibited, it can be used as a subterfuge for getting *ribā al-nasī'ah.*

Of the six commodities specified in the *ḥadīth*, two (gold and silver) unmistakably represent commodity money used at that time. One of the basic characteristics of gold and silver is that they are monetary commodities. As a matter of fact, each of the six commodities mentioned in the *ḥadīth* has been used as a medium of exchange at some time or the other. Hence, it has been generally concluded that all commodities used as money enter the sweep of *ribā al-faḍl.* Furthermore, the requirement of spot payment in monetary transactions has implications for future sales of currencies. These are still in the process of discussion between the *fuqahā',* economists and bankers.

The other four commodities specified in the *ḥadīth* represent staple food items. There is a difference of opinion with respect to the *ʿillah* for the prohibition in this case. One opinion argues that since all four commodities are sold by weight or measure (Ḥanafī, Ḥanbalī, Imamī and Zaydī) therefore, all items which are so saleable are subject to *ribā al-faḍl.* A second opinion is that since all four items are edible, *ribā al-faḍl* is involved in all commodities which have the characteristic of edibility (Shafiʿī and Ḥanbalī). A third opinion is that since these items are necessary for subsistence and are storable (without being spoilt), therefore, all items that sustain life and are storable are subject to *ribā al-faḍl* (Malikī).[3]

As mentioned in the definition of *ribā* given above, anything, big or small, stipulated in the contract of loan to be paid in addition to the principle is *ribā*. Such additional payment in modern terminology is known as interest. Thus *ribā* and interest are the same. The equivalence of *ribā* to interest has always been unanimously recognized in Muslim history by all schools of

[3] For the implications of this, see Chapra (1985).

thought, this without any exception. In conformity with this consensus the Islamic Fiqh Academy of the OIC has recently issued a verdict[4] in its Resolution No. 10(10/2) upholding the historical consensus on the prohibition of interest. It has also invited governments of Muslim countries to encourage the establishment of financial institutions which operate in accordance with the principles of the *Sharīʿah* so that they may be able to respond to the needs of Muslims and save them from living in contravention of the demands of their faith.

Q.2) WHAT IS THE SCOPE OF TRANSACTIONS TO WHICH THE BAN ON *RIBĀ* IS APPLICABLE? DOES THE TERM APPLY ONLY TO THE INTEREST CHARGED ON CONSUMPTION LOANS OR DOES IT ALSO COVER PRODUCTIVE LOANS ADVANCED BY BANKING AND FINANCIAL INSTITUTIONS?

The prohibition of *ribā al-nasī'ah* essentially implies that fixing in advance a positive return on a loan as a reward for waiting is not permitted by the *Sharīʿah.* In this sense, *ribā* has the same meaning and import as the contemporary concept of interest in accordance with the consensus of all *fuqahā'* (jurists). It makes no difference whether the loan is for consumption or business purposes, and whether the loan is given (or taken) by a commercial bank, government, corporation, or an individual. Similarly, it makes no difference whether the return is a fixed or a variable percentage of the principal, or an absolute amount to be paid in advance or on maturity, or received in the form of a gift or prize or a service if stipulated as a condition (or expected as a custom) in the loan contract or an extension in its maturity.[5]

Q.3) DOES THE PROHIBITION OF *RIBĀ* APPLY EQUALLY TO THE LOANS OBTAINED FROM OR EXTENDED TO MUSLIMS AS WELL AS NON-MUSLIMS?

Resolution No. 10/2 of the Islamic Fiqh Academy mentioned above does not recognize any distinction between Muslims and non-Muslims, or between individuals and states with respect to the receipt and payment of interest. Resolutions of the Islamic Fiqh Academy are considered to reflect the consensus of *fuqahā'* at the present time. Therefore, the prohibition of *ribā* has universal application.[6]

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[4] Islamic Fiqh Academy (2000).

[5] The zero coupon bonds in modern times also fall within the scope of *ribā*.

[6] This is consistent with Islam being a universal religion that preaches the unity of mankind and the equality of all individuals, irrespective of their sex, color, nationality or faith.

Q.4) THE VALUE OF PAPER CURRENCY DEPRECIATES IN INFLATIONARY SITUATIONS. IN ORDER TO COMPENSATE LENDERS FOR THE EROSION IN THE VALUE OF THEIR PRINCIPAL, A SCHEME OF "INDEXATION" HAS BEEN SUGGESTED. IS SUCH A SCHEME ACCEPTABLE FROM AN ISLAMIC POINT OF VIEW?

The question of indexation is often raised in the presence of a sustained high rate of inflation. This happens in some countries under special circumstances, when the authorities do not follow non-inflationary monetary and fiscal policies. Within the Islam perspective, it is required of monetary and fiscal authorities to refrain from following inflationary policies. However, once a country is caught in the mess of inflation, the question of a possible resort to indexation arises. The *Sharīʿah* aspect of indexation in such exceptional situations is still under consideration by the *fuqahā',* especially the OIC Fiqh Academy. While the Academy has so far allowed indexation in the case of wages and contracts fulfilled over a period of time, provided that this does not harm the economy, it has not allowed it in the case of monetary debts. Meanwhile, it allows the creditor and the debtor to agree on the day of settlement – but not before – to settle the debt in a currency other than the one specified for the debt, provided that the rate of exchange applied is the one that prevails on the settlement date. Similarly, for debts in a specific currency, due in installments, the parties may agree to settle the installments due in a different currency at the prevailing rate of exchange on the date of settlement.

PART 2

ISLAMIC MODES OF FINANCE

The whole practice of Islamic finance is based on modes that do not involve interest. As a general rule, they involve the carrying out of investment and/or the purchase of goods, services and assets. The following questions touch upon the nature and uses of Islamic modes of finance and their implications.

Q.5) WHAT ARE THE MAJOR MODES OF FINANCING USED BY ISLAMIC BANKS AND FINANCIAL INSTITUTIONS?

Islamic banks provide financing using two basic methods. The first depends on profit-and-loss sharing and includes *muḍārabah* and *mushārakah*. In this case the return is not fixed in advance and depends on the ultimate outcome of the business. The second involves the sale of goods and services on credit and leads to the indebtedness of the party purchasing those goods and services. It incorporates a number of modes including *murābahah, ijārah, salam* and *istiṣnāʿ*. The return to the financier in these modes is a part of the price. These modes of finance are unique for two main reasons. First, the debt associated with financing by way of markup results from the sale/purchase of real goods and services rather than the lending and borrowing of money. According to the prevailing *fiqh* verdicts, such debt is not marketable except at its nominal value. Secondly, the introduction into banking of modes that depend on profit and loss sharing bring important advantages.[7] It has almost the same economic effects as those of direct investment, which brings pronounced returns to economic development.

A) THE MODES OF FINANCING AVAILABLE TO ISLAMIC BANKS

Theoretically, there are a large number of Islamic modes of financing. We will limit ourselves here to a very brief review of the basic modes being used by Islamic banks, emphasizing at the same time, that the door is open to devise new forms, provided that they conform to the rules of the *Sharīʿah.*

[7] Jarhi (1981).

I. *MUḌĀRABAH* (PASSIVE PARTNERSHIP)

This is a contract between two parties: a capital owner (*rabb-al-māl*) and an investment manager (*muḍārib*). Profit is distributed between the two parties in accordance with the ratio that they agree upon at the time of the contract. Financial loss is borne by the capital owner; the loss to the manager being the opportunity cost of his own labor, which failed to generate any income for him. Except in the case of a violation of the agreement or default, the investment manager does not guarantee either the capital extended to him or any profit generation. While the provider of capital can impose certain mutually agreed conditions on the manager he has no right to interfere in the day-to-day work of the manager.

As a mode of finance applied by Islamic banks, on the liabilities side, the depositors serve as *rabb-al-māl* and the bank as the *muḍārib*. *Muḍārabah* deposits can be either general, which enter into a common pool, or restricted to a certain project or line of business. On the assets side, the bank serves as the *rabb-al-māl* and the businessman as the *muḍārib* (manager). However the manager is often allowed to mix the *muḍārabah* capital with his own funds. In this case profit may be distributed in accordance with the ratios agreed upon between the two parties, but the loss must be borne in proportion to the capital provided by each of them.

II. *MUSHĀRAKAH* (ACTIVE PARTNERSHIP)

A *mushārakah* contract is similar to that of the *muḍārabah,* with the difference that in the case of *mushārakah* both partners participate in the management and provision of capital and also share in the profit and loss. Profits are distributed between partners in accordance with agreed ratios, but the loss must be distributed in proportion to the share of each in the total capital.

III. DIMINISHING PARTNERSHIP

This is a contract between a financier (the bank) and a beneficiary in which the two agree to enter into a partnership to own an asset, as described above, but on the condition that the financier will gradually sell his share to the beneficiary at an agreed price and in accordance with an agreed schedule.

IV. *MURĀBAḤAH* (SALES CONTRACT AT A PROFIT MARKUP)

Under this contract, the client orders an Islamic bank to purchase for him a certain commodity at a specific cash price, promising to purchase such commodity from the bank once it has been bought, but at a deferred price, which includes an agreed upon profit margin called markup in favor of the bank.

Thus, the transaction consists of an order accompanied by a promise to purchase and two sales contracts. The first contract is concluded between the Islamic bank and the supplier of the commodity. The second is concluded between the bank and the client who placed the order, after the bank has possessed the commodity, but at a deferred price, that includes a markup. The deferred price may be paid as a lump sum or in installments. In the contract between the Islamic bank and the supplier, the bank often appoints the person placing the order (the ultimate purchaser) as its agent to receive the goods purchased by the bank.

V. *IJĀRAH* (LEASING)

The subject matter in a leasing contract is the usufruct generated over time by an asset, such as machinery, airplanes, ships or trains. This usufruct is sold to the lessee at a predetermined price. The lessor retains the ownership of the asset with all the rights as well as the responsibilities that go with ownership.

As a form of financing used by Islamic banks, the contract takes the form of an order by a client to the bank, requesting the bank to purchase a piece of equipment, promising, at the same time, to lease it from the bank after it has been purchased. Thus, this mode of financing includes a purchase order, a promise to lease, and a leasing contract.

VI. A LEASE ENDING IN THE PURCHASE OF THE LEASED ASSET

Leasing that ends in the purchase of the leased asset is a financing contract which is intended to transfer ownership of the leased asset to the lessee at the end of the lease agreement. This transfer of ownership is made through a new contract, in which the leased asset is either given to the lessee as a gift or is sold to him at a nominal price at the end of the lease agreement. According to a decision of the OIC Fiqh Academy, this second transfer-of-ownership contract should be signed only after termination of the lease term, on the basis of an advance promise to affect such a transfer of ownership to the lessee. Rent installments are calculated in such a manner as to include, in reality, recovery of the cost of the asset plus the desired profit margin.

VII. *AL- ISTIṢNĀ*ʿ (CONTRACT OF MANUFACTURE) AND *AL-ISTIṢNĀ*ʿ *AL-TAMWĪLĪ* (FINANCING BY WAY OF *ISTIṢNĀ*ʿ)

*Al-Istiṣnā*ʿ is a contract in which a party orders another to manufacture and provide a commodity, the description of which, delivery date, price and payment date are all set in the contract. According to a decision of the OIC Fiqh

Academy, this type of contract is of a binding nature, and the payment of price could be deferred.

Al-Istiṣnāʿ Al-Tamwīlī, which is used by Islamic banks, consists of two separate *istiṣnāʿ* contracts. The first is concluded between the beneficiary and the bank, in which the price is payable by the purchaser in future, in agreed installments and the bank undertakes to deliver the requested manufactured commodity at an agreed time. The second *istiṣnāʿ* contract is a subcontract concluded between the bank and a contractor to manufacture the product according to prescribed specifications. The bank would normally pay the price in advance or during the manufacturing process in installments. The latter undertakes to deliver the product to the bank on the date prescribed in the contract, which is the same date as that stated in the first *istiṣnāʿ* contract. The original purchaser (i.e., the bank's client) may be authorized to receive the manufactured commodity directly from the manufacturer.

VIII. *SALAM*

Salam is a sales contract in which the price is paid in advance at the time of contracting, against delivery of the purchased goods/services at a specified future date. Not every commodity is suitable for a *salam* contract. It is usually applied only to fungible commodities.

Islamic banks can provide financing by way of a *salam* contract by entering into two separate *salam* contracts, or one *salam* contract and an installments sale contract. For example, the bank could buy a commodity by making an advance payment to the supplier and fixing the date of delivery as the date desired by its client. It can then sell the commodity to a third party either on a *salam* or installments sale basis. If the two were *salam* contracts, the second contract would be for delivery of the same quantity, description, etc., as that constituting the subject-matter of the first *salam* contract. This second contract is often concluded after the first contract, as its price has to be paid immediately upon conclusion of the contract. To be valid from the *Sharīʿah* point of view, the second contract must be independent, i.e., not linked to the delivery in the first contract. Should the second contract consist of an installments sale, its date should be subsequent to the date on which the bank would receive the commodity.

B) THE UTILISATION OF ISLAMIC MODES OF FINANCING

Islamic banks utilize Islamic modes of financing on two sides: first, on the side of liabilities or resource mobilization, and second, on the side of assets or resource utilization. On the resource mobilization side, the *muḍārabah* mode,

either general or restricted to a certain business line, is the mode most frequently used. The bank and the investment deposit holders share the realized profit in accordance with the ratios agreed upon between the parties at the time of contracting. The deposits in the current account are treated as if they are loans from the clients to the bank and therefore, bear no yield to the account holders. However, being loans to the bank, their principal is guaranteed by the bank. Islamic banks have achieved significant success in attracting resources on the basis of the *muḍārabah* contract.

When utilizing these resources for income generation, Islamic banks use both fixed return modes such as *murābaḥah* and leasing and variable return modes such as *muḍārabah* and *mushārakah*. While, on the liabilities side, Islamic banks have made significant progress in using profit sharing, this is not the case on the assets side. The share of profit-sharing modes in the total financing provided by Islamic banks is very small. Most of the financing is provided on a *murābaḥah* basis. This is evident from the statistics given in Table 1. The weighted average of the share of this mode in the total financing provided by Islamic banks amounts to 66 percent.

Table 1
Distribution of Financing Provided by Islamic Banks
(Average during 1994-1996)

Institution	Total Financing (Million US$)	*Murābaḥah*	*Mushārakah*	*Muḍārabah*	Leasing	Other Modes	Total
Al Baraka Islamic Bank for Investment	119	82	7	6	2	3	100
Bahrain Islamic Bank	320	93	5	2	0	1	100
Faisal Islamic Bank, Bahrain	945	69	9	6	11	5	100
Bangladesh Islamic Bank Ltd.	309	52	4	17	14	14	100
Dubai Islamic Bank	1,300	88	1	6	0	6	100
Faisal Islamic Bank, Egypt	1,364	73	13	11	3	0	100
Jordan Islamic Bank	574	62	4	0	5	30	100
Kuwait Finance House	2,454	45	20	11	1	23	100
Islam Malaysia Bank Berhad	580	66	1	1	7	24	100
Qatar Islamic Bank	598	73	1	13	5	8	100
Simple Average	8,563	70	7	7	5	11	100
Weighted Average		66	10	8	4	12	100

Source: Iqbal, Munawar, et al. (1998).

Rational behavior in the financial market would lead Islamic banks as well as the users of their financing to strike a balance between the two modes of markup and profit sharing. Many economists are of the opinion that the current combination of financing modes prevailing in the Islamic banking industry leaves something to be desired.

Q.6) IN THE ABSENCE OF LENDING AT A RATE OF INTEREST, WHAT MODES OF FINANCING CAN BE USED FOR: A) TRADE AND INDUSTRY FINANCE, B) FINANCING THE BUDGET DEFICIT, C) ACQUIRING FOREIGN LOANS?

As a rule, all financial arrangements that the parties agree to use are lawful, as long as they do not violate Islamic principles. Islam does not stop at prohibiting interest. It provides several interest-free modes of finance that can be used for different purposes. These modes can be placed into two categories. The first category includes modes of advancing funds on a profit-and-loss-sharing basis. Examples of the first category are *muḍārabah*, timed and diminishing *mushārakah* with clients and participation in the equity capital of companies. The second category includes modes that finance the purchase/hire of goods (including assets) and services on a fixed-return basis. Examples of this type are *murābaḥah, istiṣnā*ʿ, *salam*, and leasing.

The door is open for utilizing all legitimate modes, whether to finance trade, industry, or a budget deficit through domestic or foreign sources. In the following paragraphs, we intend to recommend particular modes for financing particular transactions, although the door is wide open to select, without restriction, any of these modes.

A) MODES FOR FINANCING TRADE AND INDUSTRY

Murābaḥah, installment sale, leasing and *salam* are particularly suitable for trade while *istiṣnā*ʿ is especially suitable for industry. More specifically, in trade and industry, financing is needed for the purchase of raw materials, inventories (goods in trade), and fixed assets as well as some working capital for the payment of salaries and other recurrent expenses. *Murābaḥah* can be used for the financing of all purchases of raw materials and inventory. For the procurement of fixed assets including plant and machinery, buildings etc. either installments sale or leasing can be used. Funds for recurrent expenses can be obtained by the advance sale of final products of the company using *salam* or *istiṣnā*ʿ.

B) MODES FOR FINANCING A BUDGET DEFICIT

It must first be underlined that in an Islamic state, budget deficit should be kept to a minimum. A careful study of budget deficits in countries around the world can easily establish that such deficits are the result of either extravagant (and/or unproductive) expenditure or insufficient effort to generate tax revenue due to political reasons or both. As a matter of principle, it is the duty of citizens to fulfill all the genuine needs of government. Taking people into confidence about these needs and creating transparency in government expenditure will go a long way towards keeping budget deficits to a minimum.

In the case of unavoidable deficits, government-owned enterprises can obtain finance by way of *muḍārabah* or *mushārakah* certificates just as private companies do. Certificates could be issued to purchase equipment or utility-generating assets in order to lease them to public sector corporations. Certificates could also be issued to finance installments sales, either on the basis of *murābaḥah* or *salam* or *istiṣnā*ʿ. The government may also wish to create a pool of funds for investment in its public sector, thereby lifting some of the burden on its own budget. In addition, the government may need another fund to finance its own operations, which may not necessarily be income earning. It can accomplish this goal through the following means:

- Create a fund that would be used to finance public sector activities through profit sharing as well as markup modes. Certificates held by contributors to this fund can be marketable, provided that the majority of funds are advanced on profit sharing or leasing bases.
- Own income-earning assets, which the government may use to generate marketable goods and services. The government may create an independent legal entity that floats *public property certificates* and uses the proceeds to purchase those assets and rent them back to the government or any other entity that can use them for productive purposes. The government can use the sales proceeds to cover its budget deficit. Certificates issued for this purpose would be marketable.

C) AN ALTERNATIVE TO FOREIGN LOANS

To provide an alternative to foreign borrowing, arrangements could be made to attract foreign as well as domestic funds through two ways:

I. The Issue of Certificates

Public as well as private enterprises can issue *mushārakah* (partnership) and *ijārah* (leasing) certificates to finance projects, especially development projects, in addition to floating stocks. Certificates can be denominated in foreign as well as domestic currencies[8] and carry a predetermined proportion of the profit earned by their respective projects. The certificates issued can be restricted to a particular project or earmarked to a group of projects. Obviously, the latter kind provides more security through diversification.

II. The Establishment of Funds

Funds could be established to finance the economic activities of public and private enterprises on equity, partnership, leasing and markup basis. They can attract funds through the issue of shares and certificates of various values and maturities and in domestic as well as foreign currencies. Funds can be established either to finance a certain sector, for example agriculture, industry and infrastructure, a particular industry, for example textiles, household durables, etc., or a conglomerate of projects.

[8] When the exchange rate of the domestic currency enjoys a reasonable measure of stability due to rational monetary and fiscal policies, the need for issuing certificates in foreign currencies would be greatly reduced.

PART 3

ISLAMIC BANKING

Before the first Islamic bank was established, the understanding of Islamic banking relied mainly on theoretical models developed by a variety of scholars. Now, theoretical contributions as well as real-life practices of Islamic banking have clarified the picture. The following questions bring forward the most important facts associated with Islamic banks. They provide the reader with a taste of the mainstream thinking among Islamic economists and bankers.

Q.7) WHAT IS AN ISLAMIC BANK? HOW DIFFERENT IS IT FROM A CONVENTIONAL BANK?

Before we define what an Islamic bank is like, it is better to give a short description of conventional banking. Conventional banking does not follow one pattern. In Anglo-Saxon countries, commercial banking dominates, while in Germany, Switzerland, the Netherlands, and Japan, universal banking is the rule. Naturally, then, a comparison between banking patterns becomes inevitable

Commercial banking is based on a pure financial intermediation model, whereby banks mainly borrow from savers and then lend to enterprises or individuals. They make their profit from the margin between the borrowing and lending rates of interest. They also provide banking services, like letters of credit and guarantees. A proportion of their profit comes from the low-cost funds that they obtain through demand deposits. Commercial banks are prohibited from trading and their shareholding is severely restricted to a small proportion of their net worth.

Because of the fractional reserve system, they produce derivative deposits, which allow them to multiply their low-cost resources. The process of bank lending is, however, subject to some problems that can make it inefficient. Borrowers usually know more about their own operations than lenders. Acting as lenders, banks face this information asymmetry. Because borrowers are in a position to hold back information from banks, they can use the loans they obtain for purposes other than those specified in the loan agreement exposing banks to unknown risks. They can also misreport their cash flows or declare bankruptcy fraudulently. Such problems are known as moral hazard. The ability of banks to secure repayment depends a great deal on whether the loan is effectively used for its purpose to produce enough returns for debt servicing. Even at

government level, several countries have borrowed billions of dollars, used them unproductively for other purposes and ended up with serious debt problems. Banks can ascertain the proper use of loans through monitoring but it is either discouraged by clients or is too costly and, hence, not commercially feasible. Hence, why the purpose for which the loan is given plays a minimal role in commercial banking. It is the credit rating of the borrower that plays a more important role.

By contrast, universal banks are allowed to hold equity and also carry out operations like trading and insurance, which usually lie beyond the sphere of commercial banking. Universal banks are better equipped to deal with information asymmetry than their commercial counterparts. They finance their business customers through a combination of shareholding and lending. Shareholding allows universal banks to sit on the boards of directors of their business customers, which enables them to monitor the use of their funds at a low cost. The reduction of the monitoring costs reduces business failures and adds efficiency to the banking system.

Following the above logic, many economists have given their preference to universal banking, because of its being more efficient. Commercial banks are not allowed to trade, except within the narrow limits of their own net worth. As we have noticed, many Islamic finance modes involve trading. The same rule cannot, therefore, be applied to Islamic banks. It may be possible for Islamic banks to establish trading companies that finance the credit purchase of commodities as well as assets. Those companies would buy commodities and assets and sell them back to their customers on the basis of deferred payment. However, this involves equity participation. We may, therefore, say that Islamic banks are closer to the universal banking model. They are allowed to provide finance through a multitude of modes including the taking of equity. Islamic banks would benefit from this by using a combination of shareholding and other Islamic modes of finance. Even when they use trade-based, debt creating modes, the financing is closely linked to real sector activities. Credit worthiness remains relevant but the crucial role is played by the productivity/profitability of the project financed.

The above comparison leads to the following brief description of an Islamic bank. Details follow under the next question.

> An Islamic bank is a deposit-taking banking institution whose scope of activities includes all currently known banking activities, excluding borrowing and lending on the basis of interest. On the liabilities side, it mobilizes funds on the basis of a *muḍarābah* or *wakālah* (agent) contract. It can also accept demand deposits which are treated as interest-free loans from the clients to the bank. and which are guaranteed. On the assets side, it advances funds on a profit-and–loss sharing or a debt-creating basis, in accordance with the principles of the *Sharīʿah*. It plays the role of an investment manager for the owners of time deposits, usually called investment deposits. In addition, equity holding as well as commodity and asset trading constitute an integral part of Islamic banking operations. An Islamic bank shares its net earnings with its depositors in a way that depends on the size and date-to-maturity of each deposit. Depositors must be informed beforehand of the formula used for sharing the net earnings with the bank.

Q.8) IF BANKING WERE TO BE BASED ON INTEREST-FREE TRANSACTIONS, HOW WOULD IT WORK IN PRACTICE?

An Islamic bank, like other banks, is a company whose main business is to mobilize funds from savers and supply these funds to businessmen/entrepreneurs. It is organized as a joint stock company with the shareholders supplying the initial capital. It is managed by shareholders through their representatives on the Board of Directors. While a conventional bank uses the rate of interest for both obtaining funds from savers and supplying these funds to businessmen, an Islamic bank performs these functions using various financial modes compatible with the *Sharīʿah.* On the resource mobilization side, it uses either the contract of *muḍārabah* or *wakālah* with the fund owners. Under the first contract, the net income of the bank is shared between shareholders and the investment deposit holders according to a predetermined profit sharing formula. In the case of loss, the same is shared in proportion to the capital contributions. As far as the nature of investment deposits are concerned, these could be either general investment deposits that enter into a pool of investment funds or specific investment accounts in which deposits are made for investment in particular projects. In addition, there are current accounts that are in the nature of an interest-free loan to the bank. The bank guarantees the principle but pays no profit on these accounts. The bank is allowed to use these deposits at its own risk.

In the case of a *wakālah* contract, clients give funds to the bank that serves as their investment manager. The bank charges a predetermined fee for

its managerial services. The profit or loss is passed on to the fund providers after deducting such a fee.

On the assets side, the bank uses a number of financial instruments, none of which involves interest, for providing finance to businesses. A wide variety of such modes of financing are now available. Many of these have been discussed before.

Q.9) DO WE REALLY NEED ISLAMIC BANKS?

This question can be divided into two parts. The first part relates to the necessity of banks in general and the needs of the whole economy that they are expected to satisfy. The second part relates to the extra value an economy would gain from banks operating according to the Islamic principles. Both parts are taken up below one by one.

With regard to whether we need banks, we can divide agents (natural as well as legal entities) in an economy into two groups, one that has the ability to exploit investment opportunities requiring more financial resources than they have. We can call this group the *investors* or the *entrepreneurs*. The second group has more financial resources than required by the investment opportunities that they are themselves able to exploit. We call them *savers*. In every economy, there is a need to transfer funds from savers to entrepreneurs. This function is performed through the process of *financial intermediation* in the financial markets, where banks are the most important operators.

Financial intermediation enhances the efficiency of the saving/investment process by eliminating the mismatches inherent in the requirements and availability of financial resources of savers and entrepreneurs in an economy. Savers are often small households who save relatively small amounts and entrepreneurs are firms who often need relatively large amounts of cash. Financial intermediaries remove this size mismatch by collecting the small savings and packaging them to suit the needs of entrepreneurs. In addition, entrepreneurs may require funds for periods relatively longer than would suit individual savers. Intermediaries resolve this mismatch of maturity and liquidity preferences again by pooling small funds.

Moreover, the risk preferences of savers and entrepreneurs are also different. It is often considered that small savers are risk averse and prefer safer placements whereas entrepreneurs deploy funds in risky projects. The role of the intermediary again becomes crucial. They can substantially reduce their own risks through the different techniques of proper risk management. Furthermore, small savers cannot efficiently gather information about opportunities to place

their funds. Financial intermediaries are in a much better position to collect such information, which is crucial for making a successful placement of funds.

The role and functions of banks outlined above are indeed highly useful and socially desirable. Hence, we do need banks. Unfortunately, their role is marred by dealing on the basis of interest and limiting their activities to mostly commercial operations as pointed out above. Islamic banks add value on both counts.

Commercial banks largely finance short-term trade, business, and personal loans. This cannot satisfy the financial requirements of venture capital. The impact of commercial banking on economic development, therefore, would be below potential. Islamic banking by contrast provides finance with greater involvement in the production process. Its financing targets both the equity as well as the working capital needs of enterprises. It is expected that its impact on economic development will be more pronounced.

The avoidance of interest by Islamic banking is an additional plus. The answers to previous questions have pointed out that allocating financial resources on a production basis is more efficient than their allocation on a purely lending basis. It has also been argued that the whole banking system would be more stable and less liable to suffer from financial crises.[9] Moreover, the existence of an interest-bearing debt market opens the domestic economy to the unexpected vicissitudes of external sources. A monetary system based on *ribā* is also unjust.[10] It allows savers and banks to get away with interest, which is a guaranteed fixed rate of return on their loans, without bearing a fair part of the risks faced by entrepreneurs.

Q.10) IS ISLAMIC BANKING VIABLE?

Islamic banking, like any other banking system, must be viewed as an evolving system. No one disputes that there is a definite desire amongst Muslim savers to invest their savings in ways that are permitted by the *Sharīʿah.* Nevertheless, they must be provided with *ḥalāl* returns on their investments. Islamic scholars and practical bankers took up that challenge and have made commendable progress in the last twenty-five years in providing a number of such instruments. However, the concepts of Islamic banking and finance are still in their early stages of development and Islamic banking is an evolving reality for continuously testing and refining those concepts.

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9 See Mirakhor (1997).

10 See Chapra, op. cit.

Islamic banking and financial institutions have now spread across several Muslim countries. Some non-Muslim countries and/or institutions e also keen to experiment with Islamic financial techniques. Various components of the Islamic financial system are now available in different parts of the world in varying depth and quality. A detailed and integrated system of Islamic banking and finance is gradually evolving.

Theoretical arguments and models developed by Islamic economists and the successful practice of hundreds of institutions in heterogeneous conditions both testify to the viability of Islamic banking. The average growth rate of deposits in Islamic banks over the past twenty years has been over ten percent per annum. Many studies testify to the great success of Islamic banks in mobilizing resources. According to one of these studies[11], the relative growth rate of Islamic banks during the period 1980-1986 surpassed, in most cases, that realized by other banks. Another study noted that, "These institutions have come of age now and realized a high degree of success in respect of market penetration. This is considered remarkable in view of the fact that the markets in which these Islamic banks were established have had highly developed and well-established commercial banks. Moreover, some of those markets, especially in the Gulf region, were considered replete with banks".[12]

Another manifestation of the success of Islamic banking is the fact that many conventional banks have also started using Islamic banking techniques in the conduct of their business, particularly in dealing either with Muslim clients or in predominantly Muslim regions.

Q.11) HOW DOES ISLAMIC BANKING FARE *VIS-À-VIS* CONVENTIONAL BANKING?

The answers given to Questions 8 and 9 contain many elements of the answer to this question. We will start with a review of those elements from a slightly different angle, and proceed to provide some empirical evidence on the performance of Islamic banks as compared to conventional banks.

Islamic banks are supposed to operate along the lines of universal banking. In addition, the modes of finance they employ include both profit-and-loss-sharing modes as well as debt creating modes. The latter modes involve finance of purchase of commodities on credit with a mark-up. In order to compare Islamic to conventional banking, we need first to compare universal to commercial banking and second to see what advantages the use of profit sharing modes may bring to the banking industry.

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[11] Nienhaus (1988).
[12] Wilson, Rodney (1990).

Economists have pointed out several advantages for the use of universal banking as compared to commercial banking. In addition, Islamic economists have advanced a number of arguments in favor of financing based on profit sharing, as opposed to interest-based financing. We will first briefly review the advantages of universal banking vis-à-vis commercial banking and then list some of the advantages of the use of profit-sharing modes of finance.

ADVANTAGES OF UNIVERSAL BANKING[13]

i. Because they operate in a world marred by asymmetric information, banks would greatly benefit from reducing the risks emanating from moral hazard and adverse selection. By providing equity as well as non-equity finance, simultaneously, they can monitor the performance of firms obtaining finance at much lower costs than commercial banks. Because of cheaper monitoring, banking theory indicates that universal banking would be exposed to lower levels of moral hazard and adverse selection.

ii. In addition, by sitting on the firms' board of directors, banks could influence corporate governance in the whole productive sector, leading to general improvements in macroeconomic performance.

iii. Empirical work done on universal banking has found that universal banks face lower risks than commercial banks during both upturns and downturns.

iv. It was also found empirically that the risk differential between universal and commercial banks gets wider and more significant during downturns. This is rather significant, as downturns usually represent difficult times for banks to carry through.

v. The study of pre-World-War I Germany, has found that universal banking served to reduce the cost of financing industrialization in Germany relative to its corresponding level in the USA, where commercial banking is prevalent. The German financial sector reached a higher level of allocative efficiency than its American counterpart.

In addition, conventional economists dealing with monetary policy have found interest-based finance to be sub-optimal. The following summarizes those findings:

i. Charging a fixed interest rate on the loans extended would raise several questions, as the results of the operations of a certain production

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[13] For further details see Jarhi (2001).

enterprise, in which such loans are to be invested, are by no means certain. Therefore, guaranteeing, in advance, a fixed return on a loan without taking into consideration the *actual* results of the operations of the borrowing enterprise would put all business risk on the entrepreneur The contrary, however, is true and the arrangement would be fair if the financier were to participate in the actual profit or loss of the enterprise, as the case may be.

ii. Despite the fact that the rate of interest is operates in conventional economies as a price, monetary economists insist that a zero nominal interest rate is a necessary condition for optimal allocation of resources.[14] The reason is simple. After switching from metallic to fiat money, adding one marginal unit of real balances costs no real resources to the community. Therefore, imposing a positive price on the use of money would lead traders to economize on the use of money, in their pursuit to minimize their transactions costs. They would therefore use some real resources instead of money. However, when the rate of interest is zero, traders will have no incentive to substitute real resources for money. More real resources can therefore be directed to consumption and investment.

iii. When this matter was investigated within general equilibrium models, it was found that a zero interest rate is both necessary and sufficient for allocative efficiency.[15]

We can, therefore, emphasize that the Islamic teachings of a zero rate of interest is not an aberration. It even solves the problem of finding the suitable monetary policy that would guide an interest-based economy to optimal allocation of resources. As Islamic finance modes avoid lending at interest, such a problem is automatically resolved.[16]

ADVANTAGES OF PROFIT SHARING

Several theoretical studies of Islamic banking and finance introduced a pure profit-sharing model and compared it with a pure interest-based model. While Islamic banks are expected to mix profit-sharing with debt-creating modes, the pure profit-sharing model was useful as a comparative approach. Those studies have shown that a system, which is based on profit sharing is not only viable, but also carries with it many advantages which make it superior to an interest-based one.[17]

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[14] Friedman (1969).
[15] Wilson, Charles (1979) and Cole and Kocherlakota (1998).
[16] Jarhi, op. cit.
[17] For more detailed discussions of various points see: Chapra, op. cit and Mirakhor, op.cit.

i. The allocation of financial resources on the basis of profit-and-loss sharing gives maximum weight to the profitability of the investment, whereas an interest-based allocation gives it to credit worthiness. We can expect the allocation made on the basis of profitability to be more efficient than that made on the basis of interest.

ii. A system based on profit sharing would be more stable compared to one based on a fixed interest rate on capital. In the first, the bank is obliged to pay a fixed return on its obligations regardless of their fate, should the economic conditions deteriorate. In the latter, the return paid on the bank's obligations depends directly on the returns of its portfolio of assets. Consequently, the cost of capital would adjust itself automatically to suit changes in production and in other business conditions. Furthermore, any shock, which might befall the obligations' side of the balance sheet, would be automatically absorbed. This flexibility not only prevents the failure of the enterprises seeking funds, but also ensures the existence of a necessary harmony between the firm's cash flow and its repayment obligations, that element which enables the financial system to work smoothly.

iii. Since bank assets are created in response to investment opportunities in the real sector of the economy, the real factors related to the production of goods and services (in contrast with the financial factors) become the prime movers of the rates of return to the financial sector.

iv. The transformation of an interest-based system into one based on profit-sharing helps achieve economic growth as this results in increasing the supply of venture or risk capital and, consequently, encourages new project owners to enter the realm of production as a result of more participation in the risk-taking.

In addition to these theoretical arguments, empirical evidence also confirms the superiority of Islamic over conventional banking. Comparative studies have shown that in terms of crucial performance criteria Islamic banks as a group fare better than conventional banks. One such study[18] gives the following results:

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[18] Iqbal et al. (1998).

Table 2

Key Financial Indicators: Islamic Banks
***vis-à-vis* Conventional Banks (1996)**

(Percentages)

Indicator	Top Ten World	Top Ten Asian	Top Ten Middle-Eastern East	Top Ten Islamic
(1)	(2)	(3)	(4)	(5)
Capital/Asset Ratio	4.8	4.2	7.6	9.7
Profit on Capital	16.1	17.2	16.3	21.8
Profit on Assets	0.9	1.1	1.5	1.4

Source: Iqbal, Munawar et al. (1998).

From the evidence given above, it appears that Islamic banks' performance in terms of profitability in general, meets international "standards". However, it should be noted that conventional banks' depositors are guaranteed their principal amounts, and hence bear less risk than Islamic banks' depositors. Therefore, the depositors of Islamic banks would genuinely expect a higher rate of return to compensate for the extra risk. The current rates of profits on assets of the Islamic banks may not be enough to meet that expectation. As a matter of fact, if one looks at the rates of return offered to depositors, it can be seen that in general these are not attractive. Therefore, we can conclude that while Islamic banking is quite attractive as a business, there is need to make the rates of return paid to depositors more attractive. In the long run Islamic banks cannot and should not rely merely on the "loyalty" of their customers for religious reasons. They must be able to pay them more than the market rate of interest by an amount equivalent to a risk premium.

The above figures reflect comparative banking performance in a mixed environment of Islamic as well as conventional banking. In a predominantly Islamic banking environment, results are expected to tip further in favor of Islamic banking. However, this remains an assertion to be tested empirically.

Q.12) HOW MANY ISLAMIC BANKS ARE WORKING AT PRESENT AND WHERE?

Islamic banks have spread in all parts of the Islamic World alongside conventional banks. Some conventional banks, both in and outside Islamic countries, have found in Islamic banking an innovation worthy to be followed.

Therefore, a number of them have opened branches, windows and funds, which provide Islamic financial and banking services.

Thus the practice of Islamic banking, at present, takes one of the following forms:

A) Islamic banks and financial institutions operating within a financial system where all banks are Islamised;

B) Islamic banks and financial institutions operating alongside other conventional banks;

C) *Sharīʿah*-compliant branches, windows and funds established by some conventional banks and financial institutions; and

D) The Islamic Development Bank (IDB) in Jeddah, which is an international financial institution operating in accordance with the rules of the *Sharīʿah.*

The following is a general description of the work of these banks:

A & B) ISLAMIC BANKS AND FINANCIAL INSTITUTIONS

According to one source the number of Islamic banks and financial institutions currently operating the world over was 176 in 1997. Their geographical distribution is given in Table 3.

Table 3

Distribution of Islamic Financial Institutions Operating in 1997 by Area

Area	Number of IFI's	%
South & South East Asia	82	47
Gulf Cooperation Council	21	12
Other Countries in the Middle East	26	15
Africa	35	20
Europe, America & Australia	12	6
Total	176	100

Source: International Union of Islamic Banks, *Directory of Islamic Banks and Financial Institutions*, 1997, Jeddah.

These figures show that South & South East Asia ranks first in the number of IFIs operating there, with the countries of the Gulf Cooperation Council (GCC) and other Middle East countries ranking second. While the above figures give an idea about the geographical distribution of IFIs, they do not indicate clearly the 'relative strength' of Islamic banking in the various areas. To give a better idea about such strength, Table 4 shows the total deposits and assets of IFIs operating in the various regions. It is clear from these figures that the bulk of Islamic banking activity is concentrated in the Middle East region and countries of the GCC. These two areas account for 73 percent of Islamic banking activities.

Table 4

Financial Resources of IFI's by Region
(End of 1997)

Region	Total Deposits (Million US$)	%	Total Assets (Million US$)	%
Asia	27.552	25	41.605	28
GCC countries	14.089	12	20.450	14
Other Middle East countries	69.076	61	83.136	56
Africa	730.00	1	1.574	1
Europe, America	1.142	1	920.00	1
Total	112.59	100	147.685	100

Source: International Union of Islamic Banks, *Directory of Islamic Banks and Financial Institutions*, 1997, Jeddah.

C) ISLAMIC BANKING OPERATIONS OF CONVENTIONAL BANKS

One of the achievements of Islamic banking is the use of Islamic modes of financing by many conventional banks. This engagement of some large multinational banks in Islamic banking has special significance. A Western observer of Islamic banking made a significant remark: "The present engagement of many conventional commercial banks in providing Islamic banking services to their clients is a cogent evidence of the success of Islamic banks".[19]

It is difficult to know with certainty how many conventional commercial banks around the globe practice Islamic banking techniques. However, even a randomly selected short list may contain some of the giants of the international banking industry such as Hong Kong and Shanghai Banking

[19] Wilson, Rodney (1990).

Corporation, Chase Manhattan, Citibank, ANZ Grindlays, Kleinwort Benson along with other banks such as the Union Bank of Switzerland, Girozentale of Australia, ABC International, the Arab Banking Corporation, the National Bank of Kuwait, the Saudi British Bank, the National Commercial Bank of Saudi Arabia, the Riyadh Bank and Bank Misr. In addition to these banks, multinational banks located in certain Islamic countries such as Pakistan, Iran and Sudan also conduct their activities in accordance with the principles of Islamic banking because the local laws require them to do so. Thus, the American Express Bank Limited, Bank of America, and Citibank conduct their commercial banking activities in Pakistan under the profit and loss sharing system.

D) THE ISLAMIC DEVELOPMENT BANK (IDB)

I. OBJECTIVES OF THE BANK

The purpose of the Bank is to foster the economic development and social progress of member countries and Muslim communities, individually and collectively, in accordance with the principles of the *Sharīʿah.*

II. FINANCIAL RESOURCES

The authorized capital of the Bank at the end of 1420H (April 5, 2000) stood at 6 billion Islamic Dinars[20] (ID) (US$ 8.2 billion). Its subscribed capital amounted to 4.1 billion Islamic Dinars (US$ 5.5 billion), whereas its paid-up capital amounted to about Islamic Dinars 2.5 billion (US$ 3.4 billion). The ordinary resources of the Bank consist of members' subscriptions (paid-up capital, reserves and retained profits), which amounted at the end of 1420H to Islamic Dinars 3.5 billion (US$ 4.8 billion).

III. THE MOBILIZATION OF RESOURCES

Unlike other financial institutions, the Bank does not support its financial resources by borrowing funds from conventional financial markets as this involves the payment of interest. For this reason, the Bank has developed new *Sharīʿah*-compliant financial schemes and instruments to support its ordinary financial resources. These schemes and instruments include the IDB Unit Investment Fund (IDB UIF) the Export Financing Scheme (EFS), which was known formerly as the Longer-term Trade Financing Scheme (LTTF) and the Islamic Banks' Portfolio (IBP).

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[20] The Islamic Dinar is considered as the IDB's accounting unit. It is equivalent in value to one Special Drawing Right (SDR) of the International Monetary Fund (IMF).

i) The Unit Investment Fund (UIF)

This is a credit Fund that started operations in 1410H (1990) with the aim of contributing to the economic development of IDB member countries through a pooling of the savings of institutional and individual investors. The initial issue of Fund units amounted to US$ 100 million, which was raised to US$ 325 million in 1996. Investments in the Fund are restricted to Islamic banks, financial institutions, pension funds, charitable organizations and similar institutions. The trading of units has been made through the redemption facility offered by the IDB in its capacity as market maker. The Fund was listed on the Bahrain Stock Exchange in January 1997. This will meet the liquidity requirement of the unit holders.

ii) The Export Financing Scheme

This Scheme was established in 1408H (1987) under the name of 'The Longer-term Trade Financing Scheme' (LTTFS) with the aim of expanding the Bank's operations in the field of trade financing to facilitate the export of member countries' commodities. The Scheme has been so designed as to finance the non-conventional commodity exports of member countries to other OIC member countries. Under this Scheme, the export market has been expanded to include member countries of the Organization for Economic Cooperation and Development (OECD).

The Scheme has its own membership and capital. At the end of 1420H, membership of the Scheme stood at 23 countries. Subscribed and paid-up capital stood at ID 315.5 (US$ 431.9 million) and ID 133 million (US$ 182 million), respectively. The share of IDB in the Scheme, which was paid from its ordinary financial resources, amounts to ID 150 million (US$ 205.3 million). The total volume of approved operations under the Scheme, from the date of its inception to the end of 1420H, amounted to ID 405 million (US$ 561 million).

iii) Islamic Banks' Portfolio for Investment and Development

In cooperation with other Islamic banks, the IDB established in 1407H (1987) an independent fund under the name of 'Islamic Banks' Portfolio for Investment and Development' (IBP). It began its operation in 1408H. The IDB manages the Portfolio in its capacity as *muḍārib* (manager). The Portfolio primarily targets customers in the private sector of member countries. In order to be consistent with the rules of the *Sharīʿah* governing the circulation of shares, the Portfolio is so designed as to include real assets, in addition to cash and debts. The initial issue certificates of ownership are not subject to circulation or assignment except among Islamic banks.

By the end of 1420H, twenty Islamic banks and financial institutions including IDB were participating shareholders in the IBP. The IBP has a fixed paid-up capital of US$ 100 million and a variable capital of US$ 280 million. In addition, it has access to funds of US$ 250 million placed by IDB as a specific deposit.

The Islamic Banks Portfolio is an income fund, which aims to preserve its capital value and distribute a steady income stream to its participants. The value of the total approved operations of the Portfolio from the date of its establishment to the end of 1420H amounted to US$ 2519 million.

IV. FINANCING ACTIVITIES

IDB extends financial support to the development projects of member countries. Unlike other multilateral financial institutions, the Bank finances its operations through a number of *Sharīʿah*-compliant financing modes. They include interest-free loans; equity participation; leasing; installments sale; profit sharing and *istiṣnāʿ* (contract of manufacture).

During the period 1396-1420H (1976-2000), IDB disbursed 95 percent of the total amounts approved for the financing of projects and technical assistance, utilizing modes of Islamic financing. Financing by way of loans, which is a soft interest-free type of financing in which the beneficiary pays only for the actual administrative cost of the loan, accounted for 33.4 percent of the total financing extended; leasing and installments sale accounted for 27.4 percent and 22.6 percent of total financing, respectively.

In addition to project financing, IDB supports the development efforts of member countries by providing finance in the form of technical assistance. In addition to the above, there are three other programs, which play an important role in the development of trade among member countries. They are (i) Import Trade Financing Operations, (ii) the Export Financing Scheme and (iii) the Islamic Banks' Portfolio for Investment and Development. IDB also gives assistance and grants to Muslim communities in non-member countries, as well as assistance from the *Waqf* (Endowment) Fund in cases of disaster. The total amount approved for operations financed by IDB, from the date of its establishment until the end of 1420H, reached ID 16.5 billion (US$ 21.90 billion), excluding cancelled operations.

PART 4

AN ECONOMY-WIDE APPLICATION OF ISLAMIC BANKING AND FINANCE

Islamic banking and finance has been applied both at the level of private enterprises as well as at the economy-wide level. Individuals of their own volition have taken initiatives to establish Islamic banks, wherever they have found them permissible, this for both religious and business reasons. Governments have also sought to apply Islamic banking and finance either partially, by allowing Islamic banking to operate side-by-side with conventional banking or by attempting to transform the whole economy to Islamic banking and finance. The latest trend is more ambitious and consequently raises numerous questions, especially in a developing country that faces numerous economic imbalances. The following questions deal with the many facets of macroeconomic applications for Islamic banking and finance.

Q.13) CAN A MUSLIM COUNTRY TRANSFORM ITS ECONOMY SUCCESSFULLY TO ISLAMIC FINANCE? WHAT ARE THE PREREQUISITES FOR SUCCESS?

Islamic modes of financing adopted by Islamic banks and financial institutions have achieved reasonably good success, although they are operating mostly in a conventional economic environment. The current success of Islamic banking and finance has been accomplished despite certain difficulties caused by the lack of a proper legal and institutional set up which can support the operation of these banks. There is no doubt that once an appropriate institutional infrastructure has been completed, their degree of success will be even greater.

Each system has its own institutional requirements, and Islamic banking and finance is no exception. Islamic banks need a number of supportive institutions and arrangements to facilitate the performance of various but necessary functions. At present, most of the Islamic banking institutions are operating within a conventional environment. They are trying to cope with the existing institutional framework, which is really meant for conventional banking. They lack the institutional support that

should cater for their special needs. The building of an appropriate institutional set-up for Islamic banking and finance represents a serious challenge. This can be accomplished in two ways. One way is to complement the conventional environment with institutions and arrangements that would facilitate the operations of Islamic banking and finance. While this is not impossible, it requires extreme care in order to provide the necessary enabling conditions for both Islamic and conventional banking and finance simultaneously. For example, banking supervision can be modeled to supervise both kinds of banks, and financial market rules can be made to provide for the enlisting of Islamic financial instruments side by side with conventional ones. Such an approach can also be considered as a first step towards a complete shift to Islamic finance.

Another way is to gradually build an infrastructure suitable for Islamic banking and finance with the aim of eventually establishing an integrated Islamic financial system at the national level to replace the current interest-based system. The system would necessarily include the required infrastructure that would facilitate the use of those financing methods and modes being used by Islamic banks. A successful conversion into an integrated interest-free system, however, has to meet certain requirements. The following represents a brief account of the areas that need to be taken into consideration.

A) PLANNED GRADUALISM

Gradualism in implementing the *Sharīʿah* injunctions is well recognized. The general juristic rule on the matter states that, ‘What cannot be attained in its entirety should not be left entirely’. For gradualism to be credible, it requires the existence of a well-conceived plan and successive or parallel steps that can transform the country from the conventional to the Islamic economic system smoothly and with the minimum of transformation costs. It would also require exerting special efforts to protect the integrity of the economic system, its institutions and structure in accordance with the conditions of each country.

It is not advisable to carry out transformation from a conventional to an interest-free banking system abruptly, as this may subject the banking system as well as the rest of the economy to needless shocks. In

addition, proper implementation of an Islamic banking system requires organizational, legal, and human resource frameworks that take time to build. Due to a lack of knowledge on the part of some banking and government organizations of the details of the new banking system, such organizations may carry over their old practices instead of engaging themselves in a conscious effort to apply the new system.

However, gradualism may sometimes be misinterpreted and taken as an excuse for procrastination and lack of will to change. Therefore, there should be a well-defined plan, with a specific time frame to effect required changes. Such a plan might include the following aspects:

- ♦ The laying down of a detailed transitional plan with intermittent phases, their components, implementation mechanisms and dates.
- ♦ An inventory of the requirements of conversion, such as laws, institutional structures, policies, other similar components of the plan, and their distribution over a period of time, which would fit into the implementation schedule.
- ♦ An annual review and evaluation to ensure adherence to the scheduled plan as well as to identify and remove any obstacles in the way of its implementation.

B) LEGAL REFORM

Laws governing banks and companies in most Muslim countries have been formulated on the basis of the Western model. They include provisions that restrict the activities of Islamic banks to the limits prescribed for conventional banks. While parties could structure the agreements that bind them together in accordance with the requirements of an Islamic contract, the execution of such agreements before the courts of law requires extra effort and cost. These and other circumstances require the enactment of special laws for Islamic banking and its practice. Such special laws would facilitate the work of Islamic banks.

In addition to the above, there is a need for laws which would allow, or obligate, financial institutions to operate in accordance with the principles of the Islamic *Sharīʿah*. In this context, the legal framework of Islamic banks and Islamic financing might include:

I. BASIC LAWS

It is better to review those laws which have an influence on the financial and banking activity in two respects: first in respect of their meeting their primary objective and, second, in terms of their compliance with the principles of the *Sharīʿah*.

II. BANKING AND FINANCIAL LAWS

These laws would concentrate on establishing and supervising banking business within the country. Such laws are already in existence in some Islamic countries, but need to be subjected to a comprehensive review, especially with respect to the following aspects:

- **The Scope of Banking and Financial Activities:** Most banking laws tend to restrict the scope of banking to that of commercial banking, whereas Islamic banking is wider in its scope to match what is known as universal banking.
- **The Prohibited and the Legitimate in Islamic Banking:** All transactions are basically legitimate; those which are prohibited could be explicitly specified by law, such as interest, *gharar* (uncertainty), *jahālah* (want of knowledge), sale of what is not in hand, gambling, and the like.[21]
- **Relations with the Central Bank:** Islamic banks in most countries operate under the supervision of the central bank and are accorded the same treatment as conventional banks. Some countries enact special laws for Islamic banking to organize the operations of specific Islamic banks and their relations with the central bank.[22] In some other countries, laws are passed to state the general rules governing the operations of Islamic banks and financial institutions, alongside conventional banks.[23] Some central banks subject Islamic banks to the same controls, conditions and organizational rules to which conventional banks are subject. There are, however, some factors that require treating Islamic banks differently from conventional banks. Some of these factors are:
    - A redesign of the role of compulsory and optional reserves. The Legal Reserve Requirement should apply only to demand

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[21] Some of these need to be introduced in the banking laws while others in the civil laws.
[22] This occurred during the establishment of certain Islamic banks in Jordan and Egypt.
[23] This has been the case in Malaysia, Turkey and the United Arab Emirates.

deposits, leaving other deposits (investment and savings) to be governed by liquidity ratios and other monitoring indicators.

- Reserves held with the central bank must be placed in profit-sharing certificates, which would allow them to earn lawful income based on the actual profit realized, and to use such deposits to apply the principle that "the central bank is the lender of last resort".
- It is important to encourage the central bank and treasury to issue Islamic financial instruments. Banks themselves and other commercial firms should follow suit. This would provide a basis for performing operations in the free market, as this is beneficial particularly as an indirect tool for the monitoring of money supply.

III. THE RIGHT OF RECOURSE TO PROCRASTINATING DEBTORS

Banks need to be able to recover their rights from a procrastinating debtor with the least cost possible. Among the ramifications of such a requirement is that the bank should not exert undue time and effort before the courts of law in its attempt to recover its dues. The existence of special tribunals for banks could probably help in solving such problems.

C) BUILDING A PROPER INSTITUTIONAL FRAMEWORK

Every system has its institutional requirements. Islamic banks alone cannot cater for all institutional requirements. The Islamic financial system is supposed to provide an alternative not only to commercial banking activities but also alternative ways and means for meeting the needs of venture capital, consumer finance, short term capital, and long term capital, etc. A number of supporting institutions/arrangements are needed to perform various functions. Even within the commercial banking arena, a number of supporting institutions/arrangements, such as a lender of last resort, insurance and re-insurance facilities, inter-bank markets, etc. need to be established.

The basic function of a financial market is to mobilize funds from the surplus units and to transfer them to the deficit units, both individual and institutional. This transfer takes place either through direct finance in securities markets or through financial intermediaries. The institutions through which direct finance works include primary markets, investment banks and secondary

markets. In order to guide the investors, there are "Rating Agencies" which evaluate the worthiness of various companies seeking funds for investment. Similarly, there are various kinds of institutions that perform the financial intermediation function. These include: depository institutions such as commercial banks, savings and loan institutions; contractual savings institutions such as insurance companies and pension funds; and investment intermediaries such as mutual funds, unit trusts and finance companies.

It should, by now, be clear that the financial system of an economy needs a comprehensive institutional arrangement to cater for the various kinds of needs of the users as well as the providers of funds. Each of the institutions mentioned above perform special functions and make a contribution towards the overall efficiency of the financial system. It is against this backdrop that the Islamic financial system has to be evolved. For all those functions, which are **needed** for the efficient working of a financial system in a modern economy, corresponding Islamic institutions need to be established.

D) THE STANDARDISATION OF FINANCING METHODS AND INSTRUMENTS

Various Islamic banks are using Islamic modes of finance in different ways. Such diversity may lead to imprecision and a lack of understanding of the true nature of those contracts. There is, thus, a need to standardize financing methods, particularly in the case of a mixed environment in which Islamic banks operate alongside conventional banks. This is all the more so given the fact that the picture does not seem to be clear to some monetary authorities with regard to applying banking controls to Islamic banks with respect to various banking products.

E) REGULATION AND SUPERVISION

The regulation and supervision of banks help to control their conduct with a view to reducing the possibility of their failure, promoting confidence in the banking system, and ensuring its stability. The supervision of Islamic banks is as important as that of conventional banks. However, some monetary authorities that manage mixed banking systems do not fully appreciate the special requirements of banking supervision relevant for Islamic banks. Some of these requirements are different from those of conventional banks; others are similar. Matters would be easier when dealing with a system of banking entirely based on Islamic principles.

The central bank should develop rules that ensure the soundness of the financial and operational conditions of Islamic banks and financial institutions. In doing so, the following guidelines could be used:

I. Financial Controls

The central bank develops and implements rules that ensure the soundness of the financial conditions of banking and financial institutions. In this regard, it enforces a number of mandatory financial ratios and rules. In an Islamic financial system these rules relate to the following issues:

- Capital adequacy.
- Liquidity ratios.
- Profit sharing ratios among different capital providers.
- Limits of exposure to various types of risk, especially with respect to a specific investment, client or mode of financing.
- Soundness of feasibility studies.
- Soundness of contracts in respect of the protection they provide for the bank's rights, for example, inclusion of all the guarantees required.
- Rules governing those operations which are linked to items outside the balance sheet.

II. Operational Controls

Because Islamic banks may have to finance projects on the basis of equity participation and profit-sharing in addition to debt-based modes, the soundness of their operations needs a type of control that goes beyond merely ensuring the solvency of debtors, which constitutes the main consideration for providing credit. For Islamic banks providing finance on a profit sharing basis, the operational soundness of the project is more important. To ascertain operational soundness, the central bank needs to undertake the following procedures:

- The application of consolidated and acceptable accounting standards, which are suitable for Islamic modes of financing.
- A review of project financing operations to ensure the soundness of the bank's performance in preparing feasibility studies and evaluations and follow-ups on project implementation.
- An evaluation of the performance of the bank in monitoring and controlling the enterprises it finances by way of equity participation or

profit sharing. This would also include looking into the ability of the bank to deal with the problems facing enterprises, and to provide them with necessary technical assistance.

III. *SHARĪʿAH* COMPLIANCE

While financial soundness may be enough for retaining the confidence of clients of a conventional bank, in the case of an Islamic bank, *Sharīʿah* compliance is equally important. An Islamic bank could fail as much due to non-compliance with the *Sharīʿah* as for financial imprudence. Therefore, it should be ensured that all activities of an Islamic bank comply with *Sharīʿah* principles. In this context, a distinction should be made between two functions:

i) *Fatwā*

The function of *fatwā* relates to the provision of the *Sharīʿah*-based opinions regarding new cases and contracts. Such opinions should be based on substantiated proofs and juridically supported evidence. It is preferable to give this function to a Council of *ʿUlamā'*, working at the national level. All contracts should be approved by this Council before implementation. The Council may also consider petitions made by individuals or institutions against the current practices of any Islamic bank or financial institution.

ii) *Sharīʿah*-based Audit

As a general practice at present, each bank selects its own *Sharīʿah* Control Board. This method of selection opens the door for variations in banking practices among Islamic banks, even those operating in the same country.

It might be preferable for the central bank to establish within its organizational structure, a department for the *Sharīʿah*-based controls and audits. This department should have a number of *ʿulamā*' in the field of Islamic jurisprudence, who are well versed in financial, legal and accounting issues. Such a department may carry out the following functions:

- To inspect a sample of documents relating to operations, such as contracts and accounting records, to ensure compliance of the operations with the approved models and juridical rules.
- To issue directives to officials of Islamic banks, in the form of bulletins and circulars, drawing their attention to common mistakes from a *Sharīʿah* point of view and ways of avoiding them.

F) OTHER REFORMS

Any reforms that would stimulate the entire economy; activate the market; enhance economic performance, including the privatization of public corporations, etc. would help the transformation of the financial system by removing previous distortions. In addition, it is necessary to introduce legislation to support the free interaction of supply and demand and, thus, mitigate restrictions and price interventions. Furthermore, reform must include balancing the budget and refraining from resorting to excessive deficit financing; and following an open door policy with international markets to improve the ability of domestic products to compete in international markets. In brief, the Islamic financial system should not be over burdened by the requirements or results of imprudent economic policies.

Q.14) ARE THERE SOME OTHER REQUIREMENTS FOR ESTABLISHING A VIABLE AND EFFICIENT FINANCIAL SYSTEM?

It is important to adopt an integrated approach to Islamic banking and financial systems, consisting of several components. The smooth operation of such a system would depend on the existence of these components, many of which have been mentioned earlier, and on the extent of the adherence to their application. In this context, we would like to emphasize some important issues that would help establish such a system and contribute to promoting its good performance. Among these are the establishment of a deep financial market, a prudent fiscal policy, highly qualified and well-trained human resources, the exchange of experience with countries having common interests, and consultations with regional and international institutions.

A) FINANCIAL MARKET

The deeper the financial markets, the easier the implementation of the Islamic financial system would be. The following steps could, therefore, be helpful:

I. THE ISSUANCE OF FINANCIAL INSTRUMENTS

Financial instruments could be issued on the basis of *mushārakah*, *muḍārabah* and leasing. They could be associated with a wide spectrum of maturity dates, diverse projects and issuing entities, whether governmental or private, to cover the needs of the financial market, whether for financing the private sector or the government.

It is useful for the authorities concerned to facilitate and encourage the issuance of such instruments/certificates and to impose such controls as to ensure their credibility. It is worthwhile emphasizing that government entities have a great role to play in issuing these Islamic financial instruments. Once the role of the central bank in financing the budget deficit regresses, the central bank could deposit a part of its issue of money with banks to invest in accordance with the principles of the *Sharīʿah*. The deposits of the central bank could be either unrestricted or restricted to investments in government projects. It could also issue to the public certificates of deposit of various types and invest their proceeds with banks.

The Treasury could also issue *Sharīʿah*-based financial instruments in both local and foreign currencies to secure funds required for the implementation of government projects. Foreign financing could also be obtained on Islamic terms.

Islamic financial institutions and foreign donor countries could be given a chance to subscribe to specific funds that undertake securitization of the assets of productive projects.

II. ORGANIZING AND CONTROLLING THE FINANCIAL MARKET

Appropriate and sound dealing with the financial market requires a high degree of transparency, especially in respect of the availability of accurate information about the entities issuing financial instruments. Therefore, it is necessary to make available to dealers full and relevant information about the *Sharīʿah*; to subject the transactions involving financial instruments to generally accepted dealing standards and to specify the minimum standards of performance that should be met by enterprises requesting the listing of their instruments on the market. In other words, it is necessary to establish trading rules that would ensure orderly and smooth exchange in the market. Rules for evaluating the investment worthiness of the enterprises issuing financial instruments are equally required. Both rules would enable dealers to carry out transactions based on an objective financial assessment of the activities and performance of the issuing enterprises.

III. DEVELOPMENT AND INNOVATION

It is important to give high priority to the development of an Islamic financial market and its linking with other markets, as this is expected to decrease the circulation of debt instruments, including short-term debt. The final result would be a good record of stability and growth in the capital market.

The door should also be open to innovation, with regard to creating new *Sharīʿah*-compliant financial instruments.

B) HUMAN RESOURCES

I. EDUCATION

The teaching of Islamic economics at high school and university levels should be encouraged. This requires the design of appropriate syllabi that combine knowledge of economics and Islamic business jurisprudence, at a level suitable to each educational stage.

III. TRAINING

The application of an Islamic banking system depends on the abilities of the central bank, the treasury, bankers and businessmen to understand the nature of the system and its requirements. This requires training and guidance at all levels. Therefore, it is appropriate to organize a number of training courses, seminars, workshops and orientation programs for staff working at different echelons of the organizational ladder.

C) THE EXCHANGE OF EXPERIENCE WITH COUNTRIES AND ORGANISATIONS WITH COMMON INTERESTS

There are countries that are interested in applying Islamic banking either partially or fully. Different countries have gained different degrees of success in various fields and posses valuable experience. There are also some financial as well as research institutions that practice as well as examine developments in the field of Islamic finance. It would be appropriate to maintain continuous dialogue with such countries and institutions to exchange experience and to benefit from the lessons learnt. It would also be useful to establish collaboration towards the realization of some common objectives through joint action.

D) CONSULTATION WITH REGIONAL AND INTERNATIONAL ORGANISATIONS

There are a number of regional and international organizations with good experience in the applied side of Islamic banking. Notable among them is the Islamic Development Bank. Others have good experience in the fields of transforming one system into another, reform and structural adjustment. The help of such institutions could be sought to benefit from their experience and financial resources in the process of applying an Islamic banking system.

Q.15) WHILE TRANSFORMING AN ECONOMY FROM AN INTEREST-BASED SYSTEM TO AN ISLAMIC SYSTEM, A NUMBER OF OPERATIONAL ISSUES ARISE. HOW CAN THESE BE HANDLED?

We will now examine 11 such issues one by one:

I. ACCOUNTS, DEPOSITS AND THE VARIOUS BANKING OPERATIONS

Banking law should specify the main categories of each type of deposits and accounts, leaving the door open for innovation through the design of new ones within the main categories. In this context, any interest-free banking system would include current accounts, savings accounts and investment accounts. Current accounts are not entitled to any returns, but their principle is guaranteed and they are subject to the legal reserve regulations. A small return is paid in respect of savings accounts, which is commensurate with their invested balances. This modest return is ascribed to the normally high cost of investing the balances of these accounts that could fluctuate from one period to another.

Regarding investment accounts, they can be unrestricted, i.e., intended to enter into the general pool of resources invested by the bank or they can be restricted to specified projects. Since they stay with banks for specified periods, each bank would invest them in its capacity as *muḍārib* (manager). The net profit earned on the bank's general pool of investment should be apportioned among investment deposits according to their size and length of stay with the bank during the financial year. The bank would take a predetermined cut from net profits in compensation for its efforts as the investment manager. Such a cut could vary with the length of maturity as well as the size of deposits.

In order to obtain more financial resources, Islamic banks may issue certificates against investment deposits. The certificates can be marketable, provided that the majority of the pool is invested in real assets by the bank. This would also provide attractive financial instruments of different sizes and maturities.

II. THE DESIGN OF NEW PRODUCTS AND FINANCIAL INSTRUMENTS AND THE STANDARDIZING OF LEGAL INSTRUMENTS

Islamic banking is open to innovation. It is in itself an innovation in the banking industry. It is possible to develop a number of products and banking instruments on the side of both resource mobilization and resource utilization as long as they do not violate any *Sharīʿah* principle. Financial instruments are

considered legal contracts that, once designed, could be put in a standard legal form.

III. RE-CONSIDERING ACCOUNTING POLICIES AND STANDARDS AND THEIR FORMULATION

Islamic banks need special accounting standards, which are suitable for the methodologies employed in resource mobilization and utilization on an interest-free basis. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has exerted great efforts to formulate these standards and put them into effect. Details of these efforts are described in the following paragraphs.

IV. THE ACCOUNTING STANDARDS APPROVED BY THE ACCOUNTING AND AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTIONS IN BAHRAIN

On the initiative of the Islamic Development Bank, Islamic banks have established the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), which has issued a number of accounting standards. These include a standard for each one of the Islamic modes of financing. To make a beginning, these standards are worthy of being adopted by all Islamic banks and financial institutions. In the meanwhile, improvements in the existing standards and the development of new ones could continue through AAOIFI. Some central banks in Islamic countries require Islamic banks to adopt these standards and the application is being supervised by the monetary authorities in those countries.

V. DEALING WITH BAD AND DELINQUENT DEBTS

The proper approach for solving the problem of non-performing debts and delinquent debtors lies in the strict application of financial discipline on both debtors and creditors alike.

Concerning debtors, this starts with compelling solvent debtors to immediately settle all their outstanding debts. Those facing a liquidity problem may be given the chance of rescheduling their debts (without additional charges) on a case-by-case basis. Debtors who are unable to settle their financial obligations may be declared bankrupt and their property may be liquidated. Those who are guilty of intentional procrastination or default may be penalized.

Institutional and banking creditors should be given the chance to recover their dues from their debtors, and to reschedule the debts of parties facing temporary repayment difficulties. These creditors should also disclose

their bad debts, the circumstances under which they were incurred and the nature of responsibility towards incurring them. Institutions and banks that are unable to recover their dues should be obliged to provide sufficient cover for their bad debts, within a reasonable period of time. If they are unable to do so, they should be subjected to appropriate warnings/punishments and corrective program. If even this does not succeed, then, as a measure of last resort, proceedings may be started for the liquidation of the bank.

It has been noticed that banks which are privately owned and subject to strict banking controls are less likely to be implicated in the mess of non-performing debts, although they may not be able to escape it altogether. If applied appropriately, Islamic banking may offer extra protection due to its linking of finance with real sector activities. Results would hinge on proper application, as is the case in all systems.

Some other factors that can provide protection against the spread of non-performing debts and delinquent debtors are:

- Increasing the provision of financing using profit/revenue/output sharing modes and reducing debt-based financing.
- Accelerating the settlement of banking disputes and establishing a legal framework, which would shorten and streamline procedures, and accelerate decision-making. For this purpose, special banking tribunals may be established.
- Transparency in dealing with delinquent and bad debts in the final accounts.
- Tightening supervisory procedures by the central bank to ascertain the credibility of financing at the time it is extended and the adequacy of the guarantees and the extent of their liquidity if the financing operation is made on the basis of indebtedness.
- Removal of those factors, which might lead to moral hazard, such as providing government guarantees to loans; offering depositors highly exaggerated guarantees; financing at margin, automatic rescheduling and the like.
- Benefiting from the investment risk fund and the non-performing debt fund in dealing with delinquent debts.

VI. PROCEDURES FOR THE SETTLEMENT AND SWAPPING OF EXISTING DEBTS AND TRANSITIONAL STEPS

The necessity of honoring contracts is well established in the *Sharīʿah*. This applies to financial obligations under previously agreed contracts. Meeting these obligations would ultimately be in the interest of the debtor enterprise/country. It would enable it to keep its credibility and avoid financial outflows, which would be the initial reaction to defaulting on the debt.

Existing debts could be settled in three ways: by immediate payment, swapping and rescheduling. Negotiating with creditors should be the starting point regarding previous interest-based debts. If they accepted exchanging such debts for stocks, *mushārakah* or *ijārah* certificates, that would solve the problem. This is particularly desirable in the case of domestic debt, when the government owns a large public sector that it plans to privatize. If debt swapping is not possible, because of the shortage of saleable government enterprises or the lack of desire on the part of creditors to buy them, then all previous debts should be repaid fully, i.e., principal and interest.

Swapping or rescheduling should not be resorted to unless the debtor has been proven unable to pay, i.e., is insolvent. In case of insolvent debtors, it is preferable to start with debt swaps, especially when the debtor has assets that he could offer to the creditor against the latter's dues. Banks might sometimes find it suitable to swap the financial rights owed to them by other parties with equity participation in the re-structured companies. This would enable banks to monitor the re-structuring process and ensure its soundness. Thus, this would help these banks recover their financial rights on the one hand, and add a positive factor to the process of re-organizing the banking house, on the other.

As shareholders of the indebted enterprise are expected to oppose the swap of debts owed by their enterprise, specific legal rules should be laid down to encourage shareholders to accept such swaps. All debtors who cannot settle their debts within a reasonable time from the date they fall due should accept swapping such outstanding debts with equities or with any other assets of their enterprise. Should such shareholders fail to conclude swapping agreements with their creditors, their enterprises would become subject to liquidation by a judicial decision.

In general, all creditors should be assured that conversion to an Islamic banking system does not cancel the existing debts. Contracts, which were concluded under the conventional financial system, should be honored, even if recourse to the "doctrine of necessity" has to be made in order to avoid shocks to the local capital markets or to foreign relations.

VII. *SHARĪʿAH* CONTROL, PLANNING AND IMPLEMENTATION

In the context of responding to Question 13 above, we have mentioned the importance of *Sharīʿah* control, its components and the way it might be organized.

VIII. ISSUES PERTINENT TO FOREIGN BANKS OPERATING IN A COUNTRY

It is customary for banks operating outside their parent countries to abide by the applicable banking laws of the host country. They are also subject to the same rules and criteria of banking supervision adopted by the central banks there.

Generally speaking, many international banks are aware of Islamic banking practices. Evidence of this is found in some large foreign banks opening branches for Islamic banking or in their provision of *Sharīʿah*-based financing services to their clients. Therefore, it is expected that no special problem related to the operations of foreign banks under Islamic banking rules will be encountered.

IX. ISSUES PERTINENT TO DOMESTIC BANKS OPERATING ON FOREIGN SOIL

Reciprocity rules under the agreements implemented by the World Trade Organization (WTO) provide that countries, which have their banks operating in a certain foreign country, should allow the banks of this certain foreign country to operate on their soil.

Domestic banks wishing to operate in a foreign country should negotiate with its monetary authority those arrangements that would allow them to avoid the use of *ribā.* Generally, banking laws in Western countries can accommodate operations of Islamic financial institutions in some form or other. However, the matter requires considerable negotiating skills and innovative solutions to obtain suitable arrangements from foreign authorities.

Nevertheless, it is probable that a bank, which desires to operate in a foreign country on an interest-free basis, will encounter transitory difficulties in adjusting the prevailing modes of financing to suit those of Islamic banking. Therefore, there is a possibility that *some* of the operations of such a bank may not be *Sharīʿah*-compliant in the beginning. However, it should be possible to overcome these difficulties within a reasonably short span of time, and to accomplish full adjustment of those modes to suit the requirements of Islamic banking.

X. A Way of Winning the Banking Society to the Side of Islamic Banking

As a new system, Islamic banking needs to win the support of the banking community. This would ultimately depend on the performance of Islamic banks. However, increasing awareness among the banking community of the main characteristics of Islamic banking is also important. No system can win the sympathy and support of others, no matter how successful it might be, without sending them a sincere and clear message. To achieve this, Islamic banks, in their capacity as members of the system and business organizations with a private stake in its continuity, can take the following measures:

- Public Relations: Provide accurate information explaining the way Islamic banks operate and how the public could benefit from their services.
- Promotion: Islamic banks should advertise their services to the public to attract more clients and maintain their loyalty.
- Education through serious communication means, academic activities and distinctive research.
- Training.
- Dialogue and exchange of experience through conferences, seminars, workshops and other similar means.
- Teaching through the inclusion of appropriate teaching materials in the economics courses taught at schools and universities.

To achieve this, those responsible for the management of the Islamic banking system should seek the assistance of experienced specialists who are knowledgeable in Islamic banking and finance. In particular, those who are capable of entering into a constructive dialogue with those working in the banking sector can be effective in helping to reach common ground with bankers.

XI. Establishing Institutions Which Would Make the Prohibition of *Ribā* More Effective

In order for Islamic banking and financial institutions to operate more efficiently and successfully, they need to establish or support the institutions that discharge the following functions:

i) Investment follow-up and audit

Many businessmen refrain from adhering to strict accounting standards, thinking that such adherence could lead to subjecting their enterprises to higher tax rates, and to the exposure of secret business practices that they do not wish to reveal. This behavior constitutes a stumbling block in the way of utilizing profit-sharing modes of financing. To overcome this, all enterprises, with the possible exception of very small firms, should be required to adopt sound accounting practices. They should be given incentives in return for such action. Serious thought should also be given to establishing special institutions to audit and follow up on investments on behalf of Islamic banks.

ii) Investment agency

Among the factors that weaken incentives for financing by way of partnership is the inability of small-size financing to effectively influence the decisions of businessmen. The smaller the size of financing, the less the bank is capable of influencing such decisions. Therefore, allowing banks and financial service companies to function as investment agents would facilitate the pooling of funds, which would permit the guiding of businessmen's decisions and allow for their rationalization and correction.

iii) Feasibility studies and their evaluation

Utilization of the Islamic modes of financing to finance projects requires the existence and evaluation of feasibility studies. This in turn requires the establishment of specialized institutions with qualified personnel for the job. The existence of such institutions would facilitate the work of Islamic banks. It would help further if a special department were to be established within the central bank to provide information that would help evaluate feasibility studies and also provide technical assistance to Islamic banks for this purpose.

iv) Islamic financial services

Islamic banks need institutions that work in the field of shares and investment certificates and help in the formation of secondary markets. Therefore, the rise of financial service organizations, whose functions include the promotion of financial instruments and the creation of a market for them, would be of great help and support to Islamic banking. Among the factors that would help the creation of such organizations is the giving of tax incentives to Islamic banks so as to benefit from their services. Similar incentives may also be offered to those organizations

v) Debt collection firms

Some economists call for the establishment of an Inter-bank Fund in which each bank would subscribe to a number of shares commensurate with its uncollected debts registered with the Fund. The acceptance of any debt by the Fund for collection would depend on the soundness and strength of the associated guarantees. The proposed Fund may lend to the bank the amount of the debt when it becomes due. The Fund would then become the bank's agent in collecting its debt from the debtor against a fee. The Fund would have the right of direct recourse to procrastinating debtors through the judicial system for repayment and compensation. This proposal needs serious consideration and evaluation.

Q.16) HOW WOULD THE ROLE OF THE CENTRAL BANK AND ITS RELATIONSHIP WITH THE BANKING SYSTEM CHANGE?

The elimination of government borrowing would make it inconsistent for the central bank to continue to issue money against treasury bills and government bonds. Such interest-bearing instruments are used as a basis for open market operations, as they represent secure and liquid financial assets. The central bank must therefore find a procedure for issuing reserve money that is not based on interest. Interestingly, any procedure that leads to avoiding lending to the government would automatically be useful in protecting the monetary authority from pressures to increase the money supply without regard to the state of the economy. Such procedures would therefore be less inflationary. The following is a suggested procedure that would enable the monetary authority to exercise effective control, tie the issuance of money to the needs of real economic growth, and employ the issued funds into real economic activities.

- The central bank monitors the national economy, especially real growth and inflation rates. It also examines the state of the demand for money arising from the production and distribution of real goods and services, and makes an estimate of the elasticity of demand for money.
- In consultation with the planning authorities, the central bank sets growth and inflation targets for the next year.
- The desired rate of monetary expansion that would be consistent with growth and inflation targets would be equal to the target rate of growth X the elasticity of demand for money plus the target rate of inflation.
- A part of the money issued by the central bank to attain the desired rate of monetary expansion would be placed in banks as investment

deposits, which would be used to advance funds to finance production and commercial activities through the use of Islamic modes of finance. Those would be termed *central bank deposits*. The proportion of M to be deposited with the banks could then be used as a monetary policy instrument.

- The central bank may wish to allocate its central deposits between banks either according to their relative performance, in proportion to the size of their assets, or some other criteria. Naturally, the first criteria would encourage efficiency in the banking system.
- The central bank can also issue central deposit certificates, CDCs, to the general public. The proceeds of CDCs would similarly be deposited and invested through the banking system. These certificates would be readily marketable, as they would carry the most diversified and least risky financial investment in the economy. The rate of return on CDCs can, therefore, be used as a benchmark in place of the rate of interest.
- Open market operations in CDCs would enable the bank to exercise effective control on the money stock. When higher monetary expansion is desired, the central bank would increase the size of central deposits through the purchase of CDCs adding their proceeds to central deposits, or directly issuing new money. There would also be other instruments in the market, especially those issued by the government and banks. The menu of money-market instruments would be found sufficiently rich to warrant active open market operations.

Q.17) AS THE ECONOMY-WIDE APPLICATION OF ISLAMIC BANKING AND FINANCE REQUIRES CAREFUL PLANNING, WHAT WOULD A PROTOTYPE PLAN LOOK LIKE?

In the following Table and passages, we present a hypothetical plan whose main features can be used as a guide. The plan contains 12 elements and spreads over 12 years divided into six stages of two years each.

Table 5

A Hypothetical Plan to Apply the Islamic Monetary System

Type of Action	1st Two Years	2nd Two Years	3RD Two years	4th Two Years	5th Two Years	6th two years
Planning	Design, Review & Start	Apply & Follow-up	Apply & Follow-up	Apply & Follow-up	Apply & Follow-up	Apply & Follow-up
Laws	Property & Corporate Laws; Sales Tax & Tariff Laws; Banking Law	Commercial Law; Income Tax Laws; *Zakāh* Law	Financial Market Law; Review	Review	Review	Review
Privatization	5% each year	10% /year Review	10% /year Review	10% /year Review	10% /year Review	Review
Govt. Subsidies	2.5% less subsidies each year[24]	2.5% less subsidies each year	5% less subsidies each year	5% less subsidies each year	5% less subsidies each year	Review
Other Public Spending	Reorganize, Cost Cutting & Better Control	Remove Over-staffing & Provide Work Incentives	Develop & Apply Efficiency Standards[25]	Performance Evaluation	Performance Evaluation	Performance Evaluation
Tax Reform	Sales or VAT; Overhaul of Collection Dept.	Income Tax Modernize Collection Dept.	Modernize Collection Dept.			
Budget Deficit	Max 10% of GDP	Max 7% of GDP	Max 5% of GDP	Max 2% of GDP	Max 1% of GDP	Max 1% of GDP
Public Debt	Debt Relief; Debt Management	Debt-equity Swapping; Islamic Finance	Debt-equity Swapping; Islamic Finance	Debt Management Islamic Finance	Debt Management Islamic Finance	Debt Management
Monetary Reform	Universal + Islamic Banking,[26] Islamic Money Market	No Commercial Banking[27]	Only Islamic Banking[28]	Islamic Financial Market		
Monetary Discipline	M1growth 15% or less; A ceiling on borrowing from the Central Bank;	M1growth 10% max; no credit rationing; reduce borrowing from Central Bank	No borrowing from Central Bank; only indirect policy tools; M1growth within real GDP growth	Central Bank independence		

[24] Starting with subsidies to public enterprises.
[25] This should be done for both work and expenditures. Standards would be comparable to those applied to the private sector.
[26] The banking system would become mixed containing commercial, universal and Islamic banks.
[27] All commercial banks would transform to either universal or Islamic banking.
[28] All universal banks would switch to Islamic banking.

Exports	Removal of all export restrictions	Export Finance Schemes	Incentives to export-based industries	Incentives to Direct Investment		
Current Account Deficit	Max 10% of GDP	Max 8% of GDP	Max 5% of GDP	Max 4% of GDP	Max 3% of GDP	Max 1% of GDP

Each phase implements that part of the plan related to each element. Such implementation is timed over the six phases to allow gradual evolvement of the system, so that it becomes, at the sixth stage, an Islamic economic system. The following paragraphs explain the actions taken successively for each element in each phase, as a way to explain the above Table.

I. PLANNING

Transformation to the new economic system requires a planning process. The first two years should be sufficient to formulate the plan, review it and start its implementation. It would also be practical to anticipate some of the transformation requirements and start implementing them in the first stage. This will become obvious later on. The next five stages will mainly constitute the execution, follow-up and evaluation of the plan.

II. LAWS

There are basic legal requirements for the establishment of an Islamic economic system. The first phase may involve surveying existing laws with a view to determine where modifications or new laws are necessary for building an interest-free economy. The same phase may also involve the issue of new property laws and corporate laws or adjusting the existing ones accordingly. It may also include laws establishing sales or value-added taxes as laws governing customs and duties on foreign trade.

The Islamic economic system requires laws protecting private property. In addition, corporate laws must open the door for public as well as private enterprises to operate in an Islamic fashion. This involves avoiding using inputs or producing products that are unlawful.[29] It should also include avoiding lending and borrowing at a rate of interest.

Quite often, the economy may be suffering from imbalances as well as structural problems. Imbalances may include inflation, government budget deficits, and balance of payments deficit. Structural problems may include a large public external as well as domestic debt, a large public sector, and a weak private sector that is encumbered with many restrictions. The foreign sector may also suffer from heavy tariff and non-tariff restrictions, complicated procedures choking trade and capital flows, as well as foreign exchange restrictions. Obviously, the government needs to embark upon a financial adjustment program to reduce imbalances, coupled with a structural adjustment program that would reduce sources of inefficiency.

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[29] Unlawful products include liquor, narcotics, tobacco products, pork products and the like.

To cater for those needs, the first phase should include the enactment of laws to install the sales or the value-added tax. Installing sales or value added taxes would go a long way towards increasing government revenues. Another law would also be needed to reorganize the foreign sector. It should include the removal of government monopoly on foreign trade, the replacement of non-tariff restrictions with tariff restrictions, the rationalization of the tariff structure in a way that increases revenues and reduces incentives to smuggle, and the removal of all restrictions on exports.

The first phase should also start with issuing laws that facilitate the establishment of the institutions necessary for developing Islamic banking and finance. A banking law would be necessary to organize three important elements necessary for the transformation to Islamic economics. The first element is to open the doors for all commercial banks to switch to universal banking. The second is to open the door for banks, once switched to adapt its operations to Islamic banking. The third is to organize the entrance of new Islamic banks. Obviously, switching to universal banking and adapting to Islamic banking must be done within a specified time limit. A period of four years, extending to the end of the second phase would be reasonable.

The second phase would include the enactment of an income tax law, if it is not already in place. This would help tap more resources for government revenues. More importantly, it would introduce an element of justice into the distribution of tax burden among income groups, as it would be expected to contain an element of progression. However, as seen from other country experiences, progressive income taxes do not fully succeed in narrowing the wealth gap among citizens. The situation could become worse for the poor, especially when the adjustment program would include the reduction of subsidies. The best solution is to enact a *Zakāh* Law that would levy *zakāh* on all incomes and/or assets, following the most expansive *fiqh* opinions in this regard.[30]

The second phase would also include issuing a law that organizes commerce in a way that insures orderly and well functioning markets. In this regard, it should include the relevant aspects of Islamic teachings regarding sale and purchase contracts, delivery, conditions, specifications, verification, etc.

The third phase would include the enactment of the financial market law. Notably, it would be better to do that early, but we realize that the legislative process in each country has its own pace. In addition, given that there is likely to be some commercial law already in effect, then this would require adjustments and refinements.

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[30] Qaradawi (1994).

In all phases, once laws are enacted, their effects must be closely watched. Further changes or mere refinements may be required as those laws are applied. Therefore, evaluation and review will be needed throughout all phases.

III. PRIVATIZATION

Thanks to private property, the management of private enterprises can be distinguished from its counterpart in public enterprises by the fact that it is exposed to the danger of bankruptcy as well as the danger of take-over. Such exposure is a necessary condition for the attainment of economic efficiency.[31] The mere change of ownership would nonetheless be insufficient for the attainment of efficiency. Another necessary condition is the prevalence of competition.[32] Privatization will therefore be defined as a policy that aims at satisfying the necessary conditions for economic efficiency, viz., private property and competition, and we use it here in this meaning.

It appears from the experience of some Islamic countries that embarked on privatization policies, notably Egypt, Morocco and Tunisia, that these were successful in avoiding many of the side effects. Such knock-on effects include an increase in unemployment associated with common public dissatisfaction, the sale of public assets at less than par value, and the dominance of foreign capital. These were avoided through gradual divestiture of government property, the use of open bidding and financial market floating and asset evaluation by specialized consultants, in addition to giving priority to domestic investors in the purchase of government assets.

Keeping this in mind, the privatization of the public sector is extended over ten years, as shown in the above Table. A process of continuous evaluation and review of policy implementation is also recommended. Meanwhile, parallel actions to strengthen competition should go hand in hand with privatization.

It is also important to decide from the beginning on how to use privatization proceeds. They can be directed to the following:

- Restructuring non-performing public enterprises.
- Repayment of domestic debt.
- Repayment of foreign debt.

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[31] Economic efficiency includes both allocative and productive efficiency.
[32] Sadik et al. (1995).

- Creating a public investment fund, which would be invested domestically to strengthen the economy on the one hand and to provide an extra source of government revenue on the other.

IV. The Rationalization of Government Subsidies

A part of the financial adjustment program is to rationalize government expenditures. An important item in this category is government subsidies. They are usually found to be badly targeted as they benefit classes of individuals outside the intended circle. Quiet often, they are given as price reductions on some basic commodities, therefore creating excess demand and attracting practices of non-price discrimination, for example on the basis of influence or connections. Better targeting of government subsidies would go a long way towards reducing them, due to the exclusion of the undeserving. In addition, reliance on direct subsidies to the poor through *zakāh*, especially when it is coupled with a program for financing micro enterprises, would enable them to stand on their own and thereby substantially reduce the need for subsidies. The reductions in government subsidies envisaged in the above tables, so that it would reach 60 percent of its original level within ten years, assumes that better targeting as well as the application of *zakāh* would be done as parallel processes.

V. Other Public Spending

This part of the plan deals with the general sources of inefficiency usually found in the public administrations of developing countries. Aspects of improvement are numerous, and those listed in the above Table are only examples. Reorganization, cost cutting, establishing better controls and incentives, eliminating overstaffing, developing and applying efficiency standards, and performance evaluation have all been mentioned.

VI. Tax Reform

One of the major sources of imbalances in the government sector is the fragile tax structure that depends mostly on foreign trade taxes as well as a variety of fees and excises. This reflects both institutional weaknesses as well as a lack of fiscal awareness. The ultimate result would be a tax system with widespread tax evasion, little contact between citizens and the tax administration, and grossly regressive tax system. The solution lies in the introduction of the new tax laws mentioned above. In addition to the enactment of such laws, the plan envisages an overhaul of the tax collection administration, in order to give it the right staff and equipment, in addition to proper training and orientation. The next step would be a full-fledged plan to modernize the departments in terms of approach, procedures, and relationship with the public.

VII. BUDGET DEFICIT

The rationalization of public expenditures, including subsidies and the promotion of public revenues through tax reform would ultimately help reduce the government budget deficit. This would be so provided the government made an extra effort to limit growth in expenditure. To help implement such a policy, the plan envisages targets for the budget deficit. To start with, a ceiling of 10 percent would be set in the first year, with an intention to reduce it gradually to 1 percent of GDP by the last phase.

VIII. PUBLIC DEBT

In the first phase, the country must seek debt relief (debt forgiveness as well as rescheduling) through active and energetic contacts with donor's forums. The fact that it is embarking on a serious and rigorous financial and structural adjustment program would go a long way in persuading donors to provide debt relief. It would also be helpful to seek the advice of international as well as regional financial institutions that would be willing to provide technical assistance for the design and implementation of the program as well as extra financial resources.

The second step is to establish a *government debt management system*. It would help monitor developments in public debt and provide concerned officials with effective reigns to stay in control of its size and service. This is especially important, as many official entities would be entitled to borrow domestically as well as externally. When such decisions are centralized, controls on government borrowing can be easily implemented.

In the second phase, and through the debt management system, schemes aimed at reducing public debt can be launched, especially through debt-equity swapping. In addition, the government as well as its public enterprises can resort to Islamic finance modes as an alternative to borrowing. At the same time, market oriented schemes for providing public utilities, like transportation, communication, water and power, can be used alongside this. This could continue to the next phases to establish a new pattern of financing government activities.

IX. MONETARY REFORM

During the first phase of the plan, structural changes in the monetary system should be made to transform all commercial banks to universal banks, while opening the door for the establishment of Islamic banks and the gradual transformation of universal banks to Islamic banking. The switch to universal banking would make the adaptation to Islamic banking much easier.

Another important step is to develop an Islamic money market, where financial instruments with short duration can be issued and exchanged. We can distinguish between instruments issued by government, central banks, and banks, as those would have a high level of security, giving them an edge as marketable instruments.

i) Instruments issued by government

- ♦ *Public property certificates* were previously mentioned as a means of providing funds for government finances. These would be readily marketable.
- ♦ Public sector finance certificates can be issued by a special government fund, and should be marketable.

ii) Instruments issued by the central bank

- ♦ Central deposit certificates, CDC's

iii) Instruments issued by banks

- ♦ Banks can establish trading companies that buy goods and sell them back through *murābaḥah*. Meanwhile, banks can issue certificates whose proceeds can be used to finance the working capital of such companies. As such, capital is revolving; its counterpart would include a high proportion of commodities and real assets. This would make it lawful to exchange such instruments, which can be issued for very short periods and readily exchanged among banks and individuals.
- ♦ Banks can establish *ijārah* funds to purchase durable assets, like machinery, equipment, means of transport, etc., and lease them to users at a specified rent. This would make it possible for such funds to issue *ijārah* certificates that bear a fixed rate of return. The certificates would also be readily marketable.
- ♦ Unrestricted investment deposit certificates, UIDC's, whose proceeds would be invested in the general pool of the bank's assets and earn their average rate of return.
- ♦ Restricted investment deposit certificates, RIDC's, whose proceeds are invested in specific projects, industries or sectors.

Q.18) IN CASE ALL INTEREST-BASED TRANSACTIONS ARE ABOLISHED FROM THE ECONOMY, WHAT WOULD BE THE ECONOMIC IMPLICATIONS ON NATIONAL AND INTERNATIONAL LEVELS?

A) AT THE NATIONAL LEVEL

I. ADOPTING THE OPERATING METHOD OF UNIVERSAL BANKING

The economic consequences of eliminating interest, at the national level, could be anticipated on the basis of considering the nature of the business operations of Islamic banks.

As previously pointed out, Islamic banks can undertake financing through partnership modes as well as sales-based modes involving fixed returns. Their practices have therefore some kinship with those of universal banking.

As noted before, universal banking offers banks a wider scope of operations, where they can follow up and monitor more closely the activities of the enterprises they finance and their performance. They can employ various monitoring techniques and procedures, including sitting on boards of directors to obtain information in their capacity as partners who have a stake in the capital of those companies. Economists believe that universal banks face fewer risks than purely commercial ones, regardless of whether the national economy is undergoing a period of economic recession or upswing. The gap between the size of risks each category has to face during times of recession becomes wider; hence, the greater the ability of universal banks to employ the monitoring techniques and, consequently, the less amenable they become to moral hazards. This gives universal banking an edge in profitability over commercial banks.

Islamic banks have the same opportunity as universal banks regarding the choice of the proper mix of financial modes. They can choose the proper mix of partnership and fixed-return modes that would afford them more effective monitoring at lower costs. For this reason, they can become relatively more profitable as well as efficient. The national economy as a whole would gain.

II. RESOURCE ALLOCATION ON PRODUCTION BASES

The most important aspect characterizing Islamic financing at the macroeconomic level is its unique method of financial resource allocation. The allocation of financial resources in a conventional economy, which revolves around the rate of interest, is based on lending criteria, where credit worthiness is the main criterion for obtaining the required funds. In an interest-free

economy, however, financial resources are allocated on the basis of production and commercial criteria. This implies that the ultimate results of the business activity financed in the fields of production and commerce play a major role in obtaining the required financing, in addition to that of credit worthiness as a secondary requirement. Resource allocation on the basis of production and commercial criteria is more oriented towards growth and development, where the financial sector remains in harmony with economic fundamentals.

As mentioned above, Islamic finance modes are of two types: partnership and markup. Once an agent obtains finance of the second type, he ends up owing a loan to the finance provider. Nonetheless, an Islamic banking system does not face problems associated with debt accumulation because the debt generated is used to finance real transactions, i.e., the purchase of real commodities and assets. In addition, the markup is set once and it is not cumulative. Furthermore, the debt is not marketable, as it is sellable only at nominal value. This makes debt renewal or accumulation much more difficult.

In this context, it is inconceivable that Islamic financing could generate debts to the extent that their volume would exceed the volume of the commercial and production activities financed. Furthermore, the bulk of debts in a conventional economy, mostly government debt, would be replaced in an Islamic economy by financing through Islamic modes or tax proceeds. There is no room for a large volume of transactions in debt instruments (bonds) as appears in conventional economies, where the volume of such transactions reaches multiples of GDP. Unlike a capitalist economy, the Islamic economy is not heavily leveraged. Thus, such an economy would be well protected against shocks resulting from debts, especially of the type faced recently by the economies of Japan and the so-called tiger countries of South East Asia.

III. Relative Stability of the Banking System

Conventional banks hold assets, resulting from personal and business finance, which can generally be riskier, than their liabilities to their depositors. The conventional banking system would, therefore, face some measure of instability, especially during the downturn of the business cycle or generally during periods of low aggregate demand. At such time, higher rates of business failures and bankruptcy could bring the average rate of return on banks' investments below the average rate of interest they have to pay on time deposits. This exposes banks themselves to business failures.

By contrast, Islamic banks guarantee only demand deposits, while sharing their risks with investment depositors. An Islamic bank would not generally be expected to incur losses, even at times of low levels of aggregate demand, because of its wider scope of activities like that of universal banks.

When the rates of return on its investments decline, so does the rate of return paid out to the depositors. The possibility of business failure faced by Islamic banking is therefore negligible when compared with its conventional counterpart. We can, therefore, conclude that Islamic banking is more stable, which in turn gives an added measure of stability to the domestic economy.

B) ADVANTAGES OF ISLAMIC FINANCING AT THE INTERNATIONAL LEVEL

There is no doubt that more openness and linkages will characterize the world to which we are moving. In this global context, domestic economies would generally be more exposed to the influences of external factors that pass through trade as well as capital flow channels. Trade flows do not seem to be a source of incessant economic stability. In addition, a single country cannot place trade controls without consulting the World Trade Organization (WTO). After repeated international financial crises, especially that which befell the South East Asian countries, economists found themselves compelled to reconsider their preference for free capital flows, especially short-term. Nor can we ignore the fact that such flows are associated with interest-based financing, where debt becomes marketable and, therefore, free moving.

In a conventional economy, debt financing comes in a pyramid-shaped chain, where foreign banks lend local banks, which in turn lend individuals and local enterprises. Most of this lending is short-term. Once foreign banks face a problem, they recall their loans from local banks, which in turn recall their loans from domestic borrowers. Thus the pyramid of debts starts to collapse, and a financial crisis ensues.

An Islamic economy would receive external capital flows using only Islamic modes of finance. Whether based on partnership or markup, those flows would be contractual and are neither marketable nor recallable on notice. We can, therefore, imagine that those who wish to provide external capital flows on markup bases to an Islamic economy would have to wait until the maturity dates of their debt before withdrawal. Those interested in providing external funds on a partnership basis would have to abide by the partnership contracts.

More flexible inroads to external capital would be found in the purchase of financial instruments issued by government, the central bank, commercial banks, and enterprises. Except for *ijārah* certificates, the rate of return on those instruments would depend on the performance of the corresponding economic units using finance. Presumably, their holders would decide whether to keep or withdraw their funds by comparing expectations of future performance with

interest rate expectations. Capital placed in those certificates would be synonymous with direct foreign investment. Their holders would have preferences towards risk that are distinct from those of debt instrument holders. Particularly, they are willing to take more risk for the higher rate of return than Islamic financial instruments provide. They would not be easily swayed by an expected small change in the rate of interest to sell their certificates.

We can, therefore, conclude that the scale of capital flight from an Islamic economy would be much narrower and less idiosyncratic than in a conventional economy. The channels that link it with the world economy bring along welcome breezes, but are less liable to carry hurricanes as in the case of conventional economies. Thus, the unique nature of the Islamic financial system could add more security to the macro economy against international economic disturbances. This is by itself an invaluable asset in the current international environment.

Q.19) A LARGE NUMBER OF MUSLIM COUNTRIES DEPEND HEAVILY ON FOREIGN LOANS FROM OTHER COUNTRIES AS WELL AS FROM INTERNATIONAL FINANCIAL INSTITUTIONS LIKE THE WORLD BANK AND THE IMF. IF INTEREST IS TOTALLY ABOLISHED FROM THE ECONOMY OF A MUSLIM COUNTRY, HOW CAN IT DEAL WITH FOREIGN COUNTRIES AND FOREIGN FINANCIAL INSTITUTIONS?

This question raises three major issues: how to deal with current debts, the economic effects of borrowing and alternatives to borrowing.

A) DEALING WITH CURRENT DEBT

It is important to emphasize at the outset that the shift to the Islamic economic system does not mean giving up the settlement of outstanding debt contracted under the conventional system. It is a basic principle of the *Sharīʿah* that Muslims should fully honor their contracts. Therefore, the principal and interest amounts of such debts that had risen from past contracts and obligations should be settled, regardless of whether they were contracted with domestic or foreign parties.

Should a country find it difficult to secure the liquidity required to settle all its outstanding debts, it could resort to one of the following courses of action:

The outstanding debts of developing countries facing economic difficulties are usually offered in markets at prices less than their nominal value. The amount of discount given varies with the economic conditions of each indebted country. It is therefore possible to negotiate directly with creditors swapping debts with equity participation and, at the same time, achieve some discount.

Meanwhile, governments of developing countries usually have a large public sector, which could be privatized in the course of a comprehensive structural adjustment program.[33] Part of the proceeds obtained from selling some of its public enterprises can be used in purchasing foreign debt at a discount. In addition, debt can be swapped for equity in public enterprises, within the desired limits of keeping the majority holding of key enterprises in the hands of nationals.

It might be preferable to give precedence to the debt-equity swapping of domestic public debt. The proceeds raised from the remaining assets of public enterprises undergoing privatization could then be used in the settlement of external public debt.

B) THE HARMFUL EFFECTS OF BORROWING

Having said that all outstanding debt must be settled, Muslim governments should strictly avoid future borrowing on the basis of interest. In this regard, we must recall the global debt crisis that started during 1982, which was accompanied by the inability of developing countries to settle their debts. The crisis continued until 1990, when developing countries returned quickly to borrowing. The debt problem rose again in 1997 in the Asian countries, and it was accompanied this time with a crisis in the foreign exchange market. This renewed heated discussions among economists. Some suspected that those crises indicated that a number of developing countries had fallen victim to the greed of some creditors on the one hand, and to the unsound economic policies of these countries, on the other.[34]

Generally, leveraged economies face what is called *the open economy dilemma*.[35] Simply stated, countries that allow free capital movements have to choose between independent monetary policies and fixed exchange rates. Nonetheless, South East Asian countries fixed their exchange rates, while attempting to have independent monetary policies.

[33] Carrying out privatization as a part of a comprehensive structural adjustment program must be done gradually and accompanied with proper safeguards.
[34] See for example, Obstfeld (1998), pp. 9-30.
[35] Rodrik (2000), pp.177-86.

What compounded their problem was the fact that heavily leveraged economies inevitably face two problems. The first is that business borrowers face disproportionately high risks (in relation to the size of equity) during periods of slow economic activities, as debts have to be repaid regardless of business conditions. This increases the rate of business failures beyond that which would prevail in the absence of leverage. The second is that expectations in the debt market are non-segmental, implying that when debts in one part of the market (a sector or a whole country) become non-performing, pessimistic expectations would not be restricted to that part. They spread all over. This phenomenon of contagion is basically due to the fact that conventional debt is marketable.[36] It exposes heavily indebted economies to business problems in other countries. The problem is compounded when the debt is short-term and when lenders of a group of countries are the same.

It has become evident from the last debt crisis that South East Asian countries allowed excessive borrowing that was predominantly short-term. As shown above, there are reasons that would make foreign capital flows a source of instability resulting from the *herding effect*. It would, therefore, be wise to steer away from borrowing as much as possible and to use, instead, the Islamic modes of financing.

C) ALTERNATIVES TO FOREIGN BORROWING

What could an Islamic country do to benefit from foreign financial resources? The key to answering this question lies in the innovative utilization of financial markets to attract foreign capital. Such innovative utilization should be made alongside a dialogue with foreign financing institutions to familiarize them with the advantages of using the Islamic modes of finance. Those modes directly finance the purchase of real assets and commodities, in contrast with conventional lending, which provides enterprises with general funds, which could be used on bureaucratic expansion or inefficient conglomeration. The use of foreign funds through Islamic modes would have a direct impact on economic activities, thereby impacting economic development in a more efficient and effective manner. There are huge amounts of resources moving between countries through equity markets. If Muslim countries can put their houses in order, there is no reason why they cannot attract some of these funds.

In this context, the following methods may be considered for attracting foreign capital:

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[36] Note the contrast with Islamic finance, where there are debt-creating modes of finance, e.g., *murābaḥah*. Such debt is not marketable; i.e., it cannot be sold at a value that is different from its nominal value.

I. The Issue of Islamic Financial Instruments in Foreign Currencies

II. The Design of Special Funds to Cater to the Needs of Specific Projects and Sectors

Examples could be:

- An infrastructure fund for use in financing roads, transport projects, building of airports and seaports, power stations etc.;
- A leasing fund;
- A trade financing fund;
- An agricultural investment fund;
- An industrial investment fund
- An housing investment financing fund, and
- A fund for financing a specific project

III. Profit-sharing

D) WHEN IS IT PERMISSIBLE TO BORROW?

It must first be noted that borrowing as such is not prohibited by the *Sharīᶜah*. If the debtor has the means and resources to pay back, borrowing is acceptable. When Islamic modes of finance are used, even if they are debt-based, there is a much higher possibility of the debtor being able to service the debt. This is so because Islamic modes are always linked to real sector activities. However, should an Islamic country exhaust all alternatives to foreign interest-based borrowing without succeeding in satisfying financial requirements for meeting the "needs" of the society, could it resort to interest-based borrowing?

The answer to this question is based on the general Islamic juridical rule providing that, "Necessity renders legitimate that which is originally illegitimate". The doctrine of *ḍarūrah* (necessity) allows temporary suspension of normal law in case of dire need. Since this doctrine can often be misused, a word of caution is in order.

The doctrine of necessity is meant to be used very sparingly. It is a rule to handle emergencies. Even in emergencies, it does not provide an automatic and unrestricted suspension of the law. First of all, it has to be determined that a

situation has arisen where the doctrine can be invoked. While in individual cases, it is the individual conscious which will determine this, in case of public application, a ruling must be given by *Sharīʿah* scholars, in consultation with the experts of the concerned field. Secondly, the suspension of the normal law is not absolute. There are limits and conditions to be observed. The Qur'ānic text providing for the doctrine, itself lays down two basic conditions: the user must accept the sanctity of the original law (implying a return to it as soon as possible) and in the meanwhile, use the exception to the minimum possible extent.

The application of the principle of necessity to foreign borrowing should be left to the discretion of the *ʿulamā'* in each country to decide after their full and accurate understanding of the country's real conditions. Interest-based foreign borrowing can only be resorted to in cases of compelling need for development purposes, which amounts to 'necessity' as determined by the *ʿulamā'*.

Even when such permission is granted, feasibility studies in respect of the projects to be financed by way of foreign borrowing should be undertaken, scrupulously reviewed and evaluated. Borrowing should be made to the extent of such necessity only and accompanied by a plan and schedule for repayment from the returns of the project to be financed.

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- In economics, he published books and articles, many of which dealing with the Arab region. In Islamic economics, he published on the comparative efficiency of interest-free and conventional economies in 1976 and on the monetary and financial structure of the Islamic economic system in 1981, in addition to several articles on Islamic economics, banking and finance.

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